December 6, 1999
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/84

10:00 a.m., July 31, 1998

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
T.A. Bernes	
	W. Szczuka
	R.J. Singh, Temporary
B. Esdar	W.-D. Donecker
E.R. Grilli	J. Spraos
	G. Vigliotti, Temporary
D.Z. Guti	
	O.-P. Lehmussaari
A. Kafka	H.F. O'Brien
	H. Mori, Temporary
W. Kiekens	J. Prader
	J. Jonáš, Temporary
K. Lissakers	B.S. Newman
J.-C. Milleron	P.M. Fremann, Temporary
A. Mirakhor	
	L. Palei, Temporary
G. O'Donnell	J. Shields
A.S. Shaalan	
M.R. Sivaraman	A.G. Karunasena
G.F. Taylor	O. Kwon
	J. Guzmán-Calafell
J. de Beaufort Wijnholds	
	A. Barro Chambrier
Y. Yoshimura	H. Ono
	O. Sein, Temporary
	Zhang F.
	Luo Y., Temporary
A.G. Zoccali	N. Eyzaguirre

R.H. Munzberg, Secretary
N.M. Hairfield, Assistant

Indonesia—Report by Staff
Staff representative: Aghevli, APD

International Capital Markets—Developments, Prospects, and Policy Issues
Staff representatives: F.C. Adams, RES; Mathieson, RES; Schinasi, RES; Mussa, RES

Also Present
Asia and Pacific Department: C.V.A. Collyns, T. Endo. European I Department: M.C. Deppler, Director; J. R. Artus, Deputy Director; Y. Horiguchi, Deputy Director. External Relations Department: P.C. Hole, Deputy Director; M.W. Bell. Fiscal Affairs Department: B.H. Potter, D.M. Simard. IMF Institute: M.S. Khan, Director. Legal Department: W.E. Holder, Deputy General Counsel. Monetary and Exchange Affairs Department: W.E. Alexander, R.B. Johnston. Policy Development and Review Department: J.T. Boorman, Director; M. Fisher, R.B. Kahn, W.C. Keller, J. Lin, L. Nielsen, R.H. Nord. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; F.C. Adams, B. Chadha, C.F. Kramer, S. Lall, J.V. Levy, P.R. Masson, D.J. Mathieson, A. Prati, A.J. Richards, J.E. Roldos, G.J. Schinasi, S. Sharma, S.S. Sriram, A.N.R. Sy, A.J. Tweedie. Secretary's Department: A.S. Linde, Deputy Secretary; S. Bhatia, P. Gotur, K.P. Moran. Treasurer's Department: T.M. Mast. Western Hemisphere Department: C.M. Loser, Director; E.R.J. Kalter. Office of the Managing Director: M. Russo, Special Advisor. Advisors to Executive Directors: P.A. Akatu, M. Askari-Rankouhi, J.A. Costa, S.S. Farid, C.M. Gonzalez, N. Jadhav, A. Levy, M.-H. Mahdavian, A.R. Palmason, E. Rodriguez, M. Sobel. Assistants to Executive Directors: A.S. Alosaimi, C. Austin, N.R.F. Blancher, J.G. Borpujari, M.A. Brooke, M. Carlens, D. Fujii, H. Hagan, J.K. Honeyfield, M. Kell, S.K. Keshava, B. Killen, K. Kpetigo, K. Lai, S.D. Melese-d'Hospital, T. Presečan, O. Schmalzriedt, Wang X., A.G. Yakub, Zubir bin Abdullah.

1. INDONESIA—REPORT BY STAFF

At Executive Board Seminar 98/5 (7/30/98), the staff reported on the conclusion of the recent meeting in Paris of the Consultative Group on Indonesia.

The Deputy Director of the Asia and Pacific Department stated that the letter of intent for the Indonesian program had been finalized in Paris on the preceding day. The meeting of the Consultative Group on Indonesia had been successful, with a total of $7.9 billion having been pledged by donors. Of that amount, about $2.3 billion was from bilateral donors, of which Japan accounted for $1.5 billion. Of the remainder, $5.6 billion was provided by international financial institutions, of which $2.7 billion had come from the World Bank and $2.2 billion from the Asian Development Bank. The official development assistance flows of $7.9 billion had essentially been anticipated in the program, and they were in addition to the $6.2 billion in exceptional financing that had been secured earlier. The total financing available for the program was about $14 billion, and on that basis, the program could be considered fully financed through the end of the fiscal year—end-March 1999.

2. INTERNATIONAL CAPITAL MARKETS—DEVELOPMENTS, PROSPECTS, AND POLICY ISSUES

The Executive Directors considered a staff paper on developments, prospects, and policy issues in international capital markets (EBS/98/121, 7/16/98; and Sup. 1, 7/16/98).

The staff representative from the Research Department stated that Executive Directors had been sent for the first time a quarterly note on emerging market financing. Previously, that note had been distributed among staff and management only, and management had asked the Research Department to make it available to Directors as well. The current note contained information on financing developments in the emerging markets during the second quarter of 1998. Although it was mostly a factual piece, it contained some analysis. Some of the data included in the note were obtained by the Fund under a contract agreement, which stipulated that that data could not be distributed widely. The contract would be renegotiated in September 1998, and the issue of distribution would also be examined. In the meantime, the quarterly note was for the personal use of Directors.

During the second quarter of 1998, financing developments had been influenced by several factors, including the weakness in Japan and in the Japanese yen, the situation in Russia, and weaknesses in commodity prices, the staff representative noted. As a result, there had been some widening of spreads on external debt, and a tightening of external financing conditions.

Mr. Mori made the following statement:

> We wish to thank the staff for another excellent and very informative set of papers on International Capital Markets. This year's report, while documenting thoroughly the Asian crisis and further developments in the international markets, especially emerging economies, raises many important issues that need to be carefully analyzed and better understood. As staff pointed out, the increasingly integrated global financial system has produced

important efficiency gains, but the new system's market dynamics are still not fully understood.

One issue is to identify the causes of the crisis. There is evidence that domestic factors as well as external conditions may have contributed to the event. For the affected economies in Asia, the strong record of growth and stability, as well as what were perceived as cautious fiscal policies, appear not to have been a safeguard to shield against a crisis of such a magnitude with deep exchange rate depreciations and widespread financial turmoil. We could argue that an accommodative monetary policy had its role in leading the economy to an overheated situation. Rapid domestic credit growth, real exchange rate overvaluations and declining stock markets could be construed as providing some indication of brewing trouble. However, one could also ask whether, had the affected economies adopted a different policy approach, a less unfavorable outcome could ensue given the surges of capital flows to these economies—and emerging markets, in general—resulting from developments in the major industrial countries.

Here, we have the question of the appropriate policy response for emerging markets that experienced capital inflows. This seems not to be trivial given the magnitude of these flows. It was suggested simply to allow the exchange rate to respond to the pressures created by these inflows through an appreciation of the exchange rate. One of the advantages in implementing this policy would be that an appreciation could help insulate the domestic money supply from the expansionary effects of capital inflows. However, some studies showed that an abrupt and large real exchange rate appreciation could also impose substantial adjustment costs on the economy. Moreover, when hedging instruments are not available, exchange rate flexibility may also deter medium-term capital flows, such as foreign direct investment, in addition to deterring export growth. Another alternative—sterilized intervention—might not be very effective on a sustained basis and could potentially create new problems in terms of the economy's adjustment, especially potential fiscal costs. A tightening of fiscal policy could also be applied, but this policy is limited because it is less flexible to counterbalance falling private savings and to avoid deterioration of the external current account.

On the origins of those large capital flows, we see changes in global macroeconomic conditions as an important determinant of these flows to emerging markets in the 1990s. Macroeconomic imbalances in the major industrial economies have played their part in the process. Both the Mexican and Asian crises were preceded by a surge of capital flows to a broad range of countries with improvements in the terms and conditions under which emerging markets could access global financial markets. U.S. dollar short-term interest rates touched levels rarely observed since the late 1960s and early 1970s. Short-term Deutsche mark and Japanese yen interest rates were around their lowest in the current decade.

Here, one could note some similarities for both the Mexican and Asian crises. Capital flows occurred in a period when banking problems were observed in mature economies. Easy monetary policy in these economies had the objective not only to boost a weak economy but also to alleviate pressures on the banking system. The expansion of short-term capital in the interbank market may, somewhat, reflect this particular context. In an uncertain environment, banks had preference for short-term lending considered safer than long-term lending because it mirrors the maturity of much of their funding and because their exposure could be more rapidly adjusted—as it really was. Moreover, an incentive for short-term interbank claims was provided by the framework of the 1988 Basle Accord, as short-term claims on banks from any country carry a relatively low risk weight under the Accord, leading to a lower cost of borrowing in the interbank market and a heavier reliance on interbank funding. There are reasons to conclude, under such a perspective, that banking system weaknesses and biases toward short-term lending in mature economies were also at the heart of the Asian and Mexican crises. Difficulties within the financial sector of these economies contributed to unprecedentedly low interest rates and a marked expansion of liquidity in their banking system, which allowed large transfers of short-term capital to emerging markets either directly through the banking system or indirectly through other financial intermediaries. The excessive accumulation of short-term capital was one important source of instability as this capital was withdrawn very quickly during the crises.

The steep decline in nominal interest rates in mature markets also stimulated a search by global investors for new investments that would help preserve the overall yield on their portfolios. Emerging market investments became increasingly attractive especially considering the significant improvements in their economic fundamentals. One could not deny the fact that initial capital flows to emerging markets certainly created a "virtuous cycle". Capital flows improved the economic performance of emerging markets because they helped relax severe liquidity constraints and thereby facilitated increased domestic investment, which stimulated economic growth.

Then, the issue of imperfections in the financial markets arises. The boom in capital inflows to Asia in the years leading up to the crisis was intermediated in large part by domestic banks, fueling an expansion of banks' balance sheets and leading to increasing exposures to liquidity, market, and credit risks. To achieve higher yields, investors in mature markets have shown a greater willingness to take on additional risks in both mature and emerging markets. There was also a decline of risk premia in many asset markets, apparently signifying a shift in preferences toward greater risk tolerance and/or a perception that risks had declined. However, it is controversial whether the flow of capital to emerging markets was sustainable, and creditors and investors were able to evaluate and price appropriately the credit risks associated with different borrowers.

Market imperfections may involve problems of information, or even a misuse of it. The competitive forces driving the globalization of universal banking firms, including the deregulation process, led to an aggressive expansion of institutions from mature economies into emerging markets, especially in Asia. Competitive pressures may also have led to a relaxation of credit standards. In a liberalized financial environment, credit demand can be more easily accommodated, but so can speculative pressures. The search for higher yields in an environment of strong growth in Asia, and the expected exchange rate stability in the region led to strong growth in bank lending flows, and to a spectacular growth of Asian fixed income and foreign exchange markets during the 1990s. Moreover, large institutional investors in mature markets also decided to increase the share of emerging market securities in their overall portfolios, stimulating relatively large portfolio flows to these markets. The volume of these flows might be large relative to the size and absorptive capacity of the economies receiving them, creating undesirable distortions.

Improved transparency and disclosure about creditor positions in emerging markets, and greater attention to risk management, may correct the informational problem as these actions serve the purpose of alerting market participants and officials when pressures might be accumulating in a market. The concern here is related to the fact that agents in private credit markets may be encouraged to undertake imprudent risks because of inappropriate evaluation of global situations, and borrowers facing low interest rates may be lured into excessive indebtedness. However, as the report pointed out, it remains to be seen in practice to what degree large swings in capital flows will be significantly reduced by making better information available to investors.

There is an argument that capital inflows were driven by implicit guarantees of stable exchange rates. The resulting unhedged currency exposures were considered as one of the key determinants of the severity and scope of the Mexican and Asian crises. These unhedged exposures were motivated by the fact that domestic interest rates were higher than foreign interest rates. An exchange rate peg or pre-announced crawl, however, becomes credible only if certain conditions—domestic and abroad—are in place, such as a high level of international reserves and/or abundant availability of resources to sustain foreign flows. Exchange rate flexibility alone cannot discourage short-term flows, especially of a speculative nature. If herding behavior occurs, especially in a situation where international liquidity is abundant, market participants take a large, one-sided bet on the evolution of economic fundamentals. Very often, financial market expectations are extrapolative—positions are built up under the projections of a continued appreciation of the exchange rates. There are payoff externalities in which the payoffs to an agent adopting an action increase in proportion to the number of other agents adopting the same action.

Developments in Asia suggest that inconsistencies may occur between individual behavior and aggregate outcome. Capital flows may reflect rational choices by many individuals, while the aggregate outcomes appear anything but rational and well informed. A buildup of unhedged short-term external foreign currency debt may reach a level which increases the probability of a major financial disruption in the event of any abrupt changes in external or internal conditions. The accumulation of short-term debt itself may change economic conditions both in terms of increasing external vulnerability and generating domestic imbalances. In the event, what was a profitable activity for early entrants can become a significant source of losses if later arrivals expand the size of that activity beyond reasonable risk/return trade-offs and their own expertise. Wherever herding behavior occurs, portfolio managers are unable to evaluate the aggregate financial positions, and may lead in times of market stress to "assume the worst" and to rapidly unwinding portfolio positions causing major disruptions.

In concluding, if one considers a series of market imperfections raised in the report, and, therefore, that market forces may not allocate capital perfectly around the world, we see a second best solution inevitable to reduce the probability of major disruptions. Sound macroeconomic policies are key elements in managing volatile capital. There is also a need to strengthen institutional arrangements, particularly in the financial sector, to cope with surges in capital flows. However, we fully agree with the staff's appraisal that capital controls need also to be contemplated in certain circumstances. Their effectiveness could be bolstered also by changes in the weight assigned to interbank loans for the purpose of computing banks' regulatory capital requirements.

Mr. Sivaraman and Mr. Jadhav submitted the following statement:

We would like to commend the staff for providing a set of very informative documents relating to the developments, prospects and policy issues in the context of international capital markets. Full of exceedingly useful information buttressed by a number of annexes, boxes and graphical illustrations, these papers not only continue the tradition of excellence established over the years, but offer yet another comprehensive examination and perspective from the staff on the Asian financial crisis.

Before getting into the detailed evaluation of the documents, our chair would like to highlight an observation from the main paper that appears on page 49: "It is also notable that with the exception of India, all of the major Asian emerging market banking systems were net debtors to BIS-reporting banks at end-1997." We wish to underline this observation because sometimes it is argued that India has been relatively unaffected by the Asian financial crisis on account of being comparatively insulated. In our view, the Fund staff's observation goes to show that in spite of the fact that the Indian economy has made important strides in the recent years toward globalization in general and attracting foreign investment in particular, financial prudence on the part of our authorities has been responsible, in no small measure, in minimizing the fall-out from the Asian financial crisis for India.

As to the substantive content, even while appreciating the research effort that has gone into producing these useful documents, the size of the main paper could have been reduced by avoiding repetition that occurs, time and again. A greater degree of coherence could also have been possible through a better integration of the writings of different staff members contributing to the paper.

An objective or dispassionate evaluation of the paper and supporting documents would call for raising, at least, three sets of interrelated issues: (1) Is the paper asking the right questions? (2) Are the questions chosen to be addressed dealt in a balanced and fair manner? (3) Is the paper providing at least proximate answers to the key issues, which in turn, could serve as a useful guide for the future?

While the staff paper has a lot to offer, it is our considered view that on all three counts, there is considerable scope for further improvement.

Since the paper examines several facets of international capital movements in the context of Asian financial crisis, one would have expected it to distinguish clearly between the virtues of free trade in goods and services on the one hand and those of free capital movements on the other.

There is a growing body of opinion which believe that capital flows are characterized by panics/herd behavior and manias and argues accordingly that free capital flows do not necessarily involve a positive sum game as free trade does and that restricted capital mobility is not operationally equivalent to protectionism.

Regrettably, the paper does not take this propitious opportunity to deal squarely with the difference in trade in widgets and in dollars. Instead, it is confined to repeated assertions regarding “important efficiency gains” arising out of unimpeded capital movement without adequately demonstrating it. It also creates doubts about the virtues of free capital mobility in a system plagued by fiscal and financial sector weaknesses.

Since the Asian financial crisis has cast a long shadow on the desirability of unfettered capital movements, a persuasive case needs to be made regarding its virtues rather than treating it as an axiomatic truth.

The Asian financial crisis is a stark and exceedingly painful reminder of what could go wrong with free capital movements without the pre-existence of an ambience of fiscal, financial and corporate rectitude. Yet, reading the paper, one gets an impression that the downside risks associated with free capital movements have been systematically underplayed. Any emerging market economy that is contemplating freer capital movement must reckon the possibility of running into crisis triggered by reversal of capital flows. As such, the potential gains from economic efficiency must be set against such downside risks. The paper does not seem to reflect this reality in the emerging financial environment.

Even when things did go wrong, as in the case of East Asia, the analysis provided in the paper seems to place a disproportionately large burden of the blame on the borrowers (and their policy makers) while letting the creditors off the hook rather lightly. In the underlying framework, the market seems to have been portrayed as a virtuous king with no debilities. All the same, the borrowers who had all the stated weaknesses also formed a part of the same market. Nevertheless, the analysis is somewhat biased in favor of one set of players, i.e. the lenders, whose interests, ultimately, all the assistance packages consciously or unconsciously, tended to protect.

While the adjustment costs inflicted on the people of the crisis-affected economies are widely known, the paper offers little or no information on the incidence, extent or distribution of losses, if any, to the globally active commercial and investment banks or investors. It would have been useful if some indication of the identity and magnitude of losses had been provided.

The paper rightly argues that the Asian crisis has underscored the importance of strong financial supervisory and regulatory structures and sound corporate governance for the efficient intermediation of private capital flows and appropriate management of risks. There is also no denying that the absence or inadequacy of one or more of these factors made the East Asian countries vulnerable to the adverse developments in the international environment. Yet, one also cannot overlook the fact that these factors were present in these economies even when these countries were booming and the international financial community was marveling at the so called Asian miracle.

The real culprit or the ultimate cause (as opposed to the proximate causes cited above) seems to be the reversal of capital flows. As such, the key to minimizing the probability of recurrence of financial crises in future lies in the ability of the international financial community in avoiding the massive reversal of capital flows.

It is in this crucial area that the paper (and indeed the existing literature) does not seem to have much to offer. On page 116, the paper concedes that "... the new (global financial) system's market dynamics are still not fully understood." While the upheavals in the financial markets are linked with changes in market sentiment, regrettably there is no direct evidence on the factors that led to changes in market sentiment itself or the timing of changes therein. It is disheartening to note that the theoretical literature on speculative attacks is incapable at the present time, to translate into what the paper calls 'simple empirically useful predictive rules".

This is an area which offers the research staff a major challenge to make meaningful contributions. Our chair would like to see it reflected, possibly, in the next year's report on capital markets.

It is in this context that we should think in terms of an international mechanism which provides a fora for lenders and borrowers to get together and minimize losses and other fall-out from financial crises. This did happen ultimately in Korea, Thailand and now in Indonesia where roll over of debt has taken place. One wonders why this wisdom did not dawn earlier, before the precipitous fall in exchange rates and the attendant social, economic and political upheavals. The lenders and borrowers might have suffered financial losses but the people of these countries who had not participated in the money game and who had nothing to fall back upon are paying the penalty; those who were once honorably employed are at the receiving end of charity now. Why can't this institution take the initiative as part of the new architecture for the

International Monetary System to develop fora where lenders and borrowers can step in at the first sign of a crisis to iron out a strategy to prevent a cataclysmic slide. This should be at the core of our endeavor of involving the private sector in resolving crises.

Finally, we would like to raise some specific issues for comments by the staff:

Both the Mexican and Asian crises were preceded by strong booms in capital inflows. One crucial difference however was that inflows into Mexico were dominated by portfolio flows while those to Asia were dominated by bank lending flows. Box II.1 (p.25) points out that reversal of capital flows in the wake of the Asian crisis in each case reflected these initial concentrations. One could go a step further and ask what, in the first place, were the reasons for such differential initial concentrations. Is it the relative difference in development of capital markets or something deeper that account for this? The staff may like to comment.

The same box places the figure of reversal (i.e. turnaround) of capital flows for the "affected" Asian countries at US$70 billion (i.e., net inflows of $40 billion in 1996 to net outflows of over $30 billion in 1997) which was equivalent of 7 percent of GDP. A report by Institute of International Finance (IIF) issued in January, 1998 indicates, however, that the reversal was of the order of US$105 billion (i.e. inflows of $93 billion in 1996 followed by outflows of $12 billion in 1997) which works out to be more than 10 percent of GDP. How could these numbers be reconciled? The staff may kindly clarify.

Box II.2 (p.26) claims that the large negative errors and omissions (E&O) recorded for the "affected" Asian countries during 1997 indicate capital outflows from these countries in excess of the recorded total net private capital flows in their balance of payments. The usefulness of the magnitude of the errors and omissions as a proxy only for unrecorded capital flight is, in our view, highly questionable. Was the phenomenon witnessed during the Mexican crisis? The aggregate data for Latin America provided in the Box certainly do not confirm the inference. Moreover, it can be seen that there is no one to one correspondence between the magnitude of the errors and omissions and severity of the crisis; the E&O for Korea was thrice as much as those in Indonesia. The data and analysis presented in Box II.2 may therefore need to be interpreted with caution.

Box II.3 (p.27) on the resilience of foreign direct investment is interesting. The studies quoted in the Box seem to argue that the resilience of FDI is a myth and such flows are no less volatile than those which are deemed to be 'short term' flows. On the other hand, Box II.1 (p.25) demonstrates that during both the Mexican as well as the Asian financial crises, the FDI inflows to the affected regions continued, "moderating only modestly in each case."

This has an important strategic implication for the emerging market economies. On the premise that the gains from economic efficiency that may flow from free capital mobility must be set against the probability of running into a crisis, it would appear that encouraging direct foreign investment while moderating, if not restricting, other flows may offer a better solution than having the extremes of free capital mobility or complete isolation, especially for the emerging market economies. As the concept of FDI itself is somewhat nebulous for the reasons stated by the staff, the above approach could, to an extent, reduce inflows. But will this not reduce vulnerability to external shocks?

We would appreciate the staff comments on this issue.

Box II.13 (p.89) clearly demonstrates the gap between the promise and performance in respect of the credit rating agencies. In principle, the credit rating agencies can significantly lower information costs to investors by providing an independent assessment of default risks. The experience during the Asian financial crisis, however, shows that the credit agencies totally missed the mark in foreseeing the vulnerabilities of the economies that faced the crisis. To make the matter worse, as concluded by the paper rightly, the rating agencies were "clearly late in downgrading the affected Asian countries", which certainly appears to have exacerbated market price movements, thereby increasing instability. The credit rating agencies could be seen even as having a destabilizing influence rather than playing their designated role of a watchdog in times of crisis as typically, it is during this period that they come out with their red cards tightening the spin on economy in its downturn. The limitations of the credit rating agencies are now clearly evident. This should be an eye-opener to those who tend to naively treat their verdict as a gospel. There are also observed differences in the approach of different rating agencies. It will be helpful to know if there is any mechanism for rating these agencies and to evaluate their credibility.

Does the staff have any comments to offer?

Mr. Bernes made the following statement:

I welcome the opportunity to review and analyze developments in international capital markets over the past twelve months. Given the extraordinary events in Asia and some other emerging economies, it is imperative that the Fund raise its understanding of the causes of the financial turmoil in Asia, especially the capital market dynamics that may have contributed to the deepening of the crisis. If necessary, the Fund's approach to the resolution of financial crises should be modified to reflect the new findings.

The report before us is comprehensive, and I acknowledge the tremendous amount of work the staff has put into preparing the report. However, as I mentioned in the context of last year's report on international capital markets, the staff's useful analyses and policy recommendations are obscured by a long and detailed description of developments in capital markets. A concise and focused report supplemented by a background paper would have been more "user friendly."

Turning to the Asian crisis and capital markets, the behavior of capital markets before and during the Asian crisis has enhanced our understanding of the underlying forces that determine the allocation and magnitude of capital flows. The surge in capital flows and their sudden reversal have triggered all the major financial crises over the past two decades. However, sudden shifts in flows are mainly the symptoms of fundamental weaknesses in financial markets rather than the cause of the crises. The staff paper on hedge funds and this year's capital markets report dispel the notion that speculators, independent of the policy course chosen by affected countries, are to blame for the recent major financial crises. I hope this message can be reinforced in the Fund's communication of its findings concerning the underlying causes of the Asian crisis and the required policy response.

I would make three broad observations on the discussion of the implications of the Asian crisis. First, surges in capital flows will likely be a permanent feature of capital markets given their rapid liberalization, developments of new financial instruments, and advances in technology. This will increase the incidence of cross-border contagion through the propagation of shocks from one country to another. Second, pursuing sound macroeconomic policies is a necessary but not sufficient condition for protecting the economy against the sudden reversal of capital flows. Strong institutional arrangements, such as effective supervision and regulation of the financial sector, are essential to reduce the likelihood of financial shocks and to enhance an economy's capacity to withstand the shocks when they occur. Third, in all recent crises, affected countries maintained a fixed or a pseudo-fixed exchange rate regime and tried to defend it at the onset of the crisis. The guarantee of a stable currency, together with implicit and explicit government guarantees for the foreign obligations of domestic institutions, distorted both borrowers' and lenders' decisions on allocation and pricing of capital flows. This led to excessive unhedged external borrowing and an inefficient capital stock. In the long run an efficient capital stock is needed to repay the debt. The sharp devaluation of Asian currencies could be attributed to a deterioration of the market's evaluation of emerging Asia's capital stock and the perception that only lower exchange rates would ensure current account stability.

In discussing how to cope with surges in capital inflows, the staff makes a strong case for the need to strengthen the banking system and other institutional arrangements such as bankruptcy procedures and accounting standards. In the context of the Asian crisis, the immediate need to address Asia's bad loans problem and to improve regulatory and prudential standards is clear. I would emphasize two other channels through which the long-term health of Asia's financial and corporate sectors could be strengthened.

First, financial sectors need to be broadened to reduce the over-reliance on banks. Asia's bond markets in particular are under-developed. A lack of long-term capital was a key shortcoming in Asia. It is worth noting here the positive role that the creation of pension funds can play in developing long-term capital markets. Second, an increased foreign bank presence can help. While often a sensitive issue, I emphasize the positive role foreign banks can play in promoting competition, efficiency, and effective supervision. Asia lags behind Latin America and Eastern Europe in this area. One exception, the Philippines, has proven to be more resilient during the crisis.

The report, in a number of places, makes reference to the role of the exchange rate in the Asian crisis, but refrains from making a definitive statement as to the appropriateness of a fixed exchange rate regime in the face of large capital inflows and the need to exit from a pegged system before concerns about the sustainability of the fixed rate are heightened. My reading of the report suggests that in Asia the maintenance of pegged exchange rate regimes for too long encouraged external borrowing and led to excessive exposure to foreign exchange risk. Further, unsuccessful attempts to defend currency pegs when pressures started to mount exacerbated the crisis as they led to one-sided bets against the currencies.

As this chair has argued in the past, currency pegs may be appropriate in some cases and at early stages of transition to a market economy when an exchange rate anchor is necessary to import the monetary discipline of a country's major trading partners. However, I would argue that in most cases countries should allow more flexibility in their exchange rate system as they gain policy credibility, particularly when they face increasing capital inflows, and switch to a different nominal anchor.

Abandoning a peg system after currency pressures have reached a crisis-level would be much more disruptive as we witnessed in the Asian crisis. The Fund seems to have given contradictory advice to the Asian countries and Russia. Thailand, Indonesia, and Korea were advised to float their currencies in the face of a sudden reversal of capital flows whereas Russia was encouraged to defend the currency even though it had experienced a sharp decline in commodity prices. I would be interested in hearing the staff's views on the rationale for the different policy prescriptions in the two cases.

I agree with the staff that countries that choose to maintain a pegged exchange rate system should strengthen prudential and reporting requirements on financial institutions and corporations. However, the costs of increased banking regulations should be weighed against the benefits of a pegged system. Too much banking regulation would hamper useful banking activities.

On the issue of capital controls, the report cites some studies on the impact of the Chilean-type controls. These studies seem to suggest, as the staff also notes, that imposing controls on short-term flows have at best a short-run and temporary impact. Over time, investors find ways to bypass the controls. Nonetheless, one of the conclusions of the report (page 138) is that policy makers may need to impose measures to restrain certain types of inflows. The conclusion seems to be much stronger than what the evidence presented in the report can support. Further work in this area—including a comparison between the costs and benefits of short-term flows—is needed before one can make policy recommendations.

In regard to mature financial markets, the key risk in mature financial markets is the failure of Japan to restructure its financial sector to cope with the realities of the integrated international capital markets, and increased deregulation associated with the "Big Bang" reforms. The launch of the Japanese version of "Big Bang" reforms in 1996 was an important step in the deregulation of the Japanese banking sector and should increase the urgency of creating a sound banking system. However, Japanese financial institutions have been slow to restructure their balance sheets and the authorities have been slow to implement reforms to reduce over-capacity, which could lead to increased profitability in the financial sector. Notwithstanding the need to prepare for the forthcoming challenges of the "Big Bang," the reform of the financial sector is crucial for a sustained economic recovery in Japan and in Asia. The fragility of the financial sector has exacerbated the current economic downturn as banks have become increasingly selective about allocating credit, and confidence levels have been further undermined.

I would add to the list of uncertainties and risks in capital markets, the launch of EMU. The adoption of a common monetary policy among the 11 EU members represents an unprecedented transfer of monetary sovereignty. The participants and the ECB will face a number of challenges such as the application of a common monetary policy to a set of countries at diverse points in the cycle and with possibly different monetary transmission mechanisms.

The elimination of exchange rate risk among members of the euro area will make it easier to compare prices across national markets and should result in increased integration and harmonization. As a result, the completion of EMU will reinforce ongoing restructuring in the financial services industry. Increased competition among markets should also lead to greater efficiency. In the transition period leading up to these changes, however, we might see short-term dislocation and turbulence.

Financial turbulence is also possible in the period between now and the end of 1998, as the European exchange rates will continue to float. Indeed, official intervention may be needed to ensure that market rates at the end of the year are equal to the bilateral parities that have been announced earlier this month. Financial markets could test the willingness of national central banks to intervene, potentially in an unlimited fashion, to support the various currencies.

The conduct of monetary policy, especially in the beginning of EMU, and the success of the new integrated payment system are critical factors in minimizing the risks associated with the establishment of EMU. It is incumbent on the ECB to promote the smooth operation of the payment system and to ensure the overall stability of the financial system. In this regard, it would be helpful if the ECB could play a coordinating role with respect to banking supervision in the euro area.

Mr. Kiekens and Mr. Jonáš submitted the following statement:

We would like to thank the staff for preparing this extensive and informative report. It includes an interesting analysis of the Asian crisis that significantly increases our understanding of the causes, course, and consequences of modern financial crises. We will comment on several of the issues for discussion suggested by the staff.

As regards mature financial markets, at present, with most advanced economies performing strongly, the greatest risk posed for the international financial system from developments in mature financial markets would be the possibility of damage to emerging markets from either a sharp correction in equity prices, or a monetary tightening with higher interest rates, undertaken to defend domestic price stability.

In some countries, and especially the United States, there is concern that equity prices may be out of line with realistic expectations about the level of long-term corporate earnings. Several factors could have contributed to a situation where investors' decisions do not adequately reflect a correct assessment of potential future earnings. One is the reallocation of international investment portfolios and the "flight to quality." A second is the heavy flow of new cash during recent years into U.S. equity mutual funds, due to an increasing preference of investors for equities over other assets.

Another potential systemic threat to the international financial system is the unfolding financial and economic crisis in Japan. This crisis could hardly have arisen at a worse moment. Because Japan is the largest economy in Asia, its financial and economic problems aggravate the severity of troubles elsewhere in the region, reducing the possibility of a swift recovery from the regional crisis and increasing the risk that financial turmoil will deepen, economic activity will remain weak, and market confidence will remain low. The situation is not improved by the fact that Japan's consensus-based policy making does not permit the authorities to take the rapid and decisive actions required to resolve the financial system's problems and, in combination with other policies, to improve consumer and business confidence sufficiently to revive domestic demand and production.

Another source of concern is the ongoing "big bang" liberalization of Japan's financial markets. It is possible that given the precarious situation of Japan's banking system and the continuing financial and economic problems, removing all restrictions on Japanese investment abroad could trigger large outflows of capital, weakening the yen and further aggravating the regional situation.

On managing capital flows, events in Asia have provided strong evidence that sudden shifts in capital flows can have disruptive effects on the real economy. As economies become more open and dependent on foreign savings, they likewise become more vulnerable to fluctuations in both domestic and foreign investors' confidence. However, as a source of financing, foreign investors are less reliable and more volatile than domestic investors because they are often more sophisticated, and in practice, harder to bring under restrictions on capital outflows.

In many cases, capital outflows are initially triggered by an external shock, such as contagion effects. When the financial and corporate sectors are fundamentally sound, there is a good chance that the effects of the initial shock will quickly fade. But if the financial and corporate sectors are weak, the initial shock could additionally weaken their situation enough to accelerate investor flight even more. The first and best defense against the risk of large shifts in capital flows is a financial and corporate sector strong enough to withstand contagion effects or other shocks. It is also important for the public sector to be healthy enough to make public funds available to offer temporary financial assistance to the private sector without threatening the country's financial stability.

If contagion is to be contained, countries must act swiftly and decisively by raising interest rates and taking other measures to keep investor confidence from eroding. That this approach is effective is demonstrated by several cases, including that of the Czech Republic. When the contagion effect from Asia reached the Czech Republic, the authorities were already adjusting their policies to correct the widening external imbalance. These policies were further strengthened after the crisis, which increased the effectiveness of the interest rate defense against a currency collapse. Now, one year after the crisis, the koruna has returned to its pre-crisis level. By way of contrast, the monetary policy response to currency pressures was initially fundamentally wrong in Thailand, where the cost of taking short-term position against the baht for three months was just 3/4 of a percentage point.

On the use of capital controls to manage capital flows, it is our impression that perhaps the staff recommends them too easily. We find it somewhat paradoxical that the staff paper recommends Chilean-style control of capital flows at a time when market pressures are forcing Chile itself to greatly reduce its reliance on this instrument, in order to attract more short-term foreign capital. In addition, the conclusions in the annex about Chile's experience with capital control are ambiguous at best. This less than persuasive evidence makes the main text's recommendation of capital control seem a bit casual and indiscriminate. We would have preferred a more cautious wording on the usefulness of such an instrument, and a better structured discussion of what circumstances call for its use. If it were really such a great idea, we would expect it to be tried in more than a handful of countries, and to produce more persuasive results.

When deciding whether Chilean-style control of capital flows can be used, it is helpful to consider the strength of the banking sector and the degree of openness of the capital account. Four different combinations of these factors are possible, and in only one of them do capital controls theoretically make sense. The four combinations are:

Case 1—a closed capital account with a weak banking system; Case 2—a closed capital account with a strong banking system; Case 3—an open capital account with a weak banking system; and Case 4—an open capital account with a strong banking system.

Appropriate strategies in the four cases might be described as follows. For Case 1—a closed capital account with a weak banking system—the focus should be on strengthening the banking system, which for various reasons cannot be done quickly, while liberalizing capital account transactions at a commensurate pace. In Case 2—a closed capital account with a strong banking system—the capital account can and should be liberalized relatively quickly, while closely monitoring the effects on the banking system. Liberalizing capital flows creates not only new investment opportunities but also new risks, and a strong financial system can quickly become weak if these new opportunities are imprudently exploited. Case 3—an open capital account with a weak banking system—is the only one where some form of capital control might be temporarily useful. To be sure, countries are not supposed to get into this situation at all, but if—whether due to improper sequencing of liberalization or an adverse shock or some other reason—a country finds itself in this situation, the unavoidably slow pace of bank system rehabilitation can justify temporarily controlling capital flows. What is crucial is to restore the strength of the banking system quickly, before the controls have time to lose their effectiveness. In Case 4—an open capital account with a strong banking system—a country has nothing much to gain from capital controls and can enjoy the benefits of free capital flows, secure in the knowledge that strength of its banking system will prevent eventual swings in capital flows from impairing its financial health to the extent that it would cause a collapse of financial intermediation and economic activity.

Turning to the role of bank intermediation, the Asian crisis has shone a strong light on the specific role of bank intermediation. The characteristic structure of Asian financial markets, where bank credit represents the major source of external financing for corporations, has been identified as a contributing factor in the crisis. One problem is that unlike marketable securities, loans are usually not priced by markets, so that observed changes in their prices cannot provide any information about the borrowers. In Asia, this negative aspect of loan financing has been further aggravated by the customary very close relationships between banks and their borrowers that often result from cross-holding of shares and other specific features of some Asian economies. And inadequate supervision and regulation ensured that the potential adverse consequences of such systems went unsuspected and undetected as long as times were good.

Given the shortcomings of overreliance on bank intermediation, we are attracted by the idea of expediting the development of capital markets in Asian countries as an alternative source of corporate financing. Borrowers that had to rely on a bond market to supply their financing needs would be subject to more stringent disclosure rules, which would go far to eliminate the present defects in corporate governance. In any case, the recent crisis may have lowered confidence in banking systems so far that they will hardly be able to resume their role as the major channel for allocating savings. In addition, better developed capital markets can assist in corporate restructuring.

In view of the important contribution of banking system weaknesses to the Asian crisis, we were disappointed that the staff was unable to give more attention to the Russian banking sector but had to base their analysis on published sources only. On page 53, the staff notes that banks in Russia were more seriously affected by the Asian crisis than elsewhere in Central and Eastern Europe. For this reason it is too bad that a more thorough analysis in the field was not possible, as a basis for a more detailed discussion of risks and problem solutions. We note that Russia's banking sector is quite small, with assets amounting to about 10 percent of GDP, so that a banking crisis cannot have as great an impact as in Asia. But Russia's future growth depends crucially on increasing financial intermediation. A banking system crisis would further undermine the public's confidence in Russian banks, already weak, and harm future growth.

In regard to economic and monetary union in Europe, our authorities are confident that the TARGET Payment System will be successful and helpful in reducing systemic risk. The TARGET system was never designed to attract retail payments. The relative high unitary transaction cost will be marginal for the payment of large amounts, and thus not a meaningful disincentive. As a central bank service, TARGET will offer a high level of security.
The possibility of using monetary reserves as collateral will reduce the cost of collateralizing intra-day credit. Finally, banks that are already participants in a central bank payment system will encounter a low threshold for TARGET system use.

The way security clearing systems operate will affect the choice of payment systems. If security transactions are settled at day's end on a net basis, corresponding payments will also be limited to a net amount to be paid, possibly via a private payment system. However, if security transactions are settled on a gross real-time basis, payments, too, will have to be accomplished on the same basis, possibly through TARGET if cash is not on hand at the security clearing system.

The staff is concerned the European System of Central Banks (ESCB) may not be prepared to handle a financial system crisis. Our authorities prefer to avoid formal rules and procedures, favoring instead an appropriate degree of "constructive ambiguity" to avoid moral hazard. That being said, there is no doubt that lending operations may be used not only for purposes of monetary policy in the strict sense, but also for the maintenance or restoration of stable and orderly market conditions in case of a liquidity squeeze. The absence of lender-of-last-resort support from the text of the ESCB statute does not compromise the authority of the ECB to grant such support, or to authorize its provision by national central banks. Both Article 105(5) of the Treaty Establishing the European Community, and Article 3.3 of the ESCB Treaty, make both the ECB and the national central banks competent to provide credit to the banking system for the purposes of averting a systemic crisis and to preserve the stability of the financial system. Such credit support must, however, be collateralized and, in the judgment of the ECB, consistent with the maintenance of price stability. In accordance with Article 18 of the ESCB statute, liquidity support can take the form of buying and selling claims and marketable instruments, whether in Euros or other currencies, or to provide credit against adequate collateral. This provides sufficient room for maneuver when acting as lender-of-last-resort. Such credit operations by a national central bank for preserving financial system stability or to assist an individual bank will need approval by the ECB, whether ad hoc or in an ex ante guideline.

Mr. Shaalan and Mrs. Farid submitted the following statement:

Let me at the outset commend the staff team responsible for the preparation of the valuable set of documents before us today. These embody an exhaustive piece of work that provides a plausible account of the dynamics of the Asian crisis and its implications for the functioning of the international financial system as well as a credible analysis of the major risks facing the global economy today, though the main paper would have benefited from a reduced size.

We find ourselves in general agreement with the staff analysis and will attempt to comment on some of the issues proposed for discussion.

We concur with the view that one of the most important immediate risks to the international financial system today arises from the persistent weakness of the Japanese economy and the unresolved fragilities of the Japanese financial sector. The combination of these two elements and the resultant downward pressure on the yen are evidently exacerbating recovery elsewhere in Asia and intensifying pressures on troubled banking systems already struggling to restructure and reform in the midst of a deep financial crisis. Domestically, slow progress in the resolution of banking sector problems continues to further undermine confidence in the economy and contributes to continued weakness in demand. Decisive action in the banking sector would hasten the return of confidence necessary to spur consumption and investment and boost economic activity. The systemic implications of Japan's financial sector problems, if left unresolved, could have significant spillover effects beyond the Asian region. Here we note that the report points to a significant exposure of the US banking sector to Japanese banks. Depending on how significant this exposure is, it could add to the gravity of the systemic implications of developments in Japan. We would appreciate further staff comment on the extent of this exposure and its potential effect on US financial markets in the unfortunate event of a currency crisis originating in the Japanese financial sector. On a related point, staff's concern that the "Big Bang" reforms underway are accelerating the opening of the Japanese securities markets and placing additional pressures on the banking system raise an important question on the sequencing of reforms. There is obviously a concern that the availability of new financial instruments , in the absence of confidence, could translate into major outflows of capital if banking problems are not addressed in a speedy and credible manner. It may be true that the scheduled phased implementation of "Big Bang" reforms, many of which are to be implemented by end December 1998, are adding to the urgency of, and hence constitute an impetus to, the acceleration of the needed banking reforms. That may well be , but we would be hesitant to exercise brinkmanship at this stage. It is also important to guard against a premature deregulation of the securities and foreign exchange markets prior to the successful resolution of banking sector difficulties. This is a lesson that has been well demonstrated in the unfolding of the recent crisis.

Another immediate risk emanates from a possible tightening of monetary policy in the U.S. and Europe, and the high valuations in the U.S. equity market, in particular. While the domestic impact of higher interest rates and of a sharp correction in the U.S. market may be manageable in view of the underlying strength of the U. S. economy and the absence of a direct impact on the commercial banking system, the global effect of such a correction could be severe, particularly on the Japanese economic and financial system and on emerging equity markets. Another risk is, of course, the still uncertain course of events in the Asian crisis countries. The possibility of a slowdown in the pace of reform and of a stronger slowdown in economic activity than foreseen could adversely affect confidence and trigger another round of currency and social turmoil.

The rapid structural changes taking place in global financial markets, and the phenomenal growth in the volume and complexity of derivatives markets in particular, also pose an added risk to the global financial system. These developments increase the likelihood that market participants may not fully understand the workings of derivatives and accordingly miscalculate the risks involved. These changes have also made it more difficult to predict where shocks will occur and the dynamics of contagion and spillover. This is an area we need to do more work on in order to strengthen and render more effective our surveillance activities.

The market behavior that generated the observed pattern of capital movements prior to the onset of the Asian crisis, namely a surge followed by an abrupt loss of market access, plus the widespread spillover effects of these movements, are likely to be a recurrent feature of the global financial system. The relevant question for emerging market countries therefore continues to be what policies can help in managing the macroeconomic and financial risks associated with large-scale and potentially volatile capital flows. Recent events have shown that sound macroeconomic policies are a necessary but not sufficient condition for financial stability. To stem the inflationary effect of a surge in capital inflows, the Fund has traditionally advised the use of either sterilization and/or a tightening of fiscal policies. Sterilization, of course, has its limitations and thus has not proven to be a useful tool in addressing heavy inflows. If used excessively, its fiscal costs place a heavy burden on fiscal policy which may have already needed tightening. Attention is also being increasingly accorded to the advantages of allowing the nominal exchange rate to appreciate as well as of maintaining flexible exchange rates that would discourage short-term inflows by introducing an element of uncertainty. The disadvantage here, of course, is that heavy capital inflows could induce large appreciations and/or high exchange rate volatility that could be detrimental to the real economy. Recent crises have also focused attention on the critical importance of strengthening financial sectors to assure an efficient intermediation of capital inflows and to minimize the adverse effects of their increased volatility. Since financial sector reform is a time-consuming process, however, there is also now an increased recognition of the desirability of instituting prudential or other regulations to influence the types of inflows, with a particular emphasis on discouraging the more short-term, potentially more destabilizing, inflows. We see much merit in the use of Chilean-type reserve requirements on external borrowing which appear to have stemmed the inflows and , more importantly, to have contributed to the desired transformation in the nature and maturity of inflows in Chile and Columbia. The Fund should also explore other avenues to address this vexing problem.

As the staff rightly note, a combination of a weak banking system and an open capital account is an "accident waiting to happen." The recent succession of crises in Asia aptly demonstrate the validity of this observation. The role of the large-scale short-term flows into the crisis economies with weak domestic financial sectors not only exacerbated the crisis but may have been one of the important factors leading to it. This is a critical lesson of the Asian crisis. It underscores the importance of continued vigilance in assuring the soundness of the banking sector at all times, as well as the need to proceed in an orderly fashion in the opening of a country's financial system. Banking sector policies and practices should encourage prudent behavior and should enable the early identification and resolution of emerging difficulties in individual banks expeditiously. Recent events have also focused attention on the modification of banking regulations to discourage borrowing banks and corporations from assuming unhedged external liabilities, particularly with short maturities. We would also underscore the need to find ways to improve the pricing of risks by foreign creditors, as indicated by the prominent role of cross-border interbank lending by financial institutions in mature economies in the recent crisis. Providers of destabilizing capital flows have a role to play in reducing the risks associated with such flows. We, therefore, look forward to the incorporation of relevant principles that would achieve this objective in the Basle Committee's Core Principles for Effective Banking Supervision.

The Asian crisis has also focused attention on a number of issues related to the nonfinancial corporate sector. Since corporate entities increasingly have access to global financial markets, the same incentives aimed at discouraging banks from assuming large short term unhedged external liabilities should apply to them. This could be accomplished through the use of taxes that would discourage external short-term borrowing. Additionally, more attention needs to be accorded to improving legal arrangements involving corporate governance, disclosure requirements and bankruptcy procedures.

Finally, the Asian crisis and its ramifications may well provide us with an important lesson with regard to the advisability of floating the exchange rate in a time of financial turmoil. The recent Asian experience casts doubt on the wisdom of switching to a flexible exchange rate system in the midst of a crisis, particularly if the banking system is weak and if the financial and /or corporate sectors carry large unhedged liabilities in foreign currencies. We wonder whether the Asian currency free fall with its attendant heavy economic and social costs could have been mitigated if the Asian crisis countries had devalued without abandoning the pegged exchange rate system. Like other Directors we would be interested in staff comment on this issue as well as whether the Asian experience contributed to the Fund's different policy prescription in the case of Russia.

Mr. Guzmán-Calafell made the following statement:

I wish to start by commending the staff for the comprehensive and informative set of papers prepared for this discussion. The emphasis placed by the papers on the Asian crisis is welcome, since an adequate understanding of its origins and repercussions is essential in attempting to enhance the stability of the world economy. By approaching this issue from a new angle, the papers provide a useful complement to the work on the financial crisis in Asia carried out in previous staff's studies. I also found the sections on the main trends and issues in the mature financial systems interesting and thought-provoking.

Turning to the Asian crisis, the papers confirm a number of features of the crisis which had already been noted in previous studies. These include for instance the role played by capital inflows and the expansion of bank credit in the period leading up to the crisis, the problems derived from weak regulatory regimes and lack of transparency in the operation of financial systems, the role of corporate governance, and others. Rather than elaborating on these issues, which have already been discussed at length, I would like to concentrate on others which in my view deserve further discussion.

The first is the remarkable resilience that foreign direct investment flows have observed during this difficult period. As shown in Table II.1, while portfolio capital and bank lending to Asia fell sharply during 1997, FDI flows to these countries remained roughly constant in the wake of the crisis. It is worth noting that a similar phenomenon was observed in 1995 after the crisis in Mexico. This provides support to the widespread view that the long term nature of FDI flows makes them more stable and therefore less likely to show large fluctuations in periods of uncertainty. I am somehow confused, however, by the information contained in Box II.3 in the report, which notes that evidence has been found concluding that "FDI and other flows labeled long term according to the traditional balance of payments definition, have generally been as volatile, and no more predictable, than flows labeled short-term." This conclusion was also stressed by the staff during our discussion of this issue last year. Since this information is inconsistent with the recent experiences, I believe some further comments by the staff would be useful.

A second feature of the crisis which is worth noting is the slow market reaction to the emergence of problems in the countries involved. The information on the evolution of spreads on bond issues in secondary markets is revealing in this respect. As shown in figure II.6, the floating of the bath in July 1997 and the events that followed initially had a relatively modest impact on spreads in the secondary markets for the Asian emerging markets, and a sharp deterioration of conditions was observed only after the emergence of financial uncertainty in Hong Kong in late October. A similar trend is observed in the case of both bank lending and equity markets. Moreover, the report emphasizes the slow response and the lax predictive analysis of rating agencies in the countries in difficulties. With this information at hand, doubts emerge on the wisdom of placing too much weight to the discipline which we frequently assume is instilled by markets.

Third, the information in the papers points repeatedly to the existence of official guarantees, especially regarding the exchange rate, as a central explanatory element of the crisis. On the one hand, they stimulated capital inflows since, according to the paper, international lenders operated under the assumption that in the event of problems at domestic financial institutions official support would be forthcoming, and that there would be no fundamental changes to exchange rate policy. Official guarantees were also a fundamental force behind the expansion of banks' balance sheets. The importance of these guarantees in fostering the growth of credit, maturity mismatches, unhedged positions, etc. is also noted in the papers.

Fifth, the papers include very useful information on the forces that determine the extent of contagion and spillover effects during a crisis of this nature. In particular, beyond the purely psychological impact, the existence of complex and not very well known linkages between emerging markets' trade and financial markets may result in the transmission of economic problems from one country to another with an unanticipated strength.

Sixth, we have to take a close look at experiences such as that of Brazil in coping with the contagion effects of turbulence in other markets.

In my view, the above mentioned features provide valuable information from which we need to draw the proper lessons. In discussing the lessons from the Asian crisis, the staff's papers include an interesting analysis in three other areas, namely, coping with surges in capital inflows, dealing with banking sector problems, and the role of the corporate sector and the bankruptcy process. Since I share in general the staff's views, I would only like to make three comments in this regard. First, the use of fixed exchange rates is a common trait of the problems faced in these three areas among the Asian countries. Therefore, the information in the paper supports the view that moving toward more flexible exchange rate regimes can enhance an economy's resilience to shocks. In any event, I fully agree with the staff that whenever the merits of using the exchange rate as a nominal anchor outweigh the accompanying risks, it is essential to tailor the prudential and reporting frameworks to the needs of the exchange rate arrangement, and hence strengthen requirements in these areas both on financial institutions and corporations.

Second, the challenges derived from the flow of capital to the emerging markets must not only be seen as a problem for the authorities of these economies. They are also a problem for the countries where the capital originates, and consequently efforts must be made in these nations as well to discourage an excessive growth of these flows. The staff points to the actions under consideration within the Basle committee to address concerns about the expansion of sovereign and interbank lending to emerging markets. These efforts are welcome, and I would appreciate the staff's opinion on their potential implications. These measures, however, concentrate on bank lending, and I wonder what can be done to act on the supply side in the case of other sensitive flows, especially portfolio investment.

Third, I agree with the staff that we have to be realistic and understand that the introduction of adequate frameworks of bank regulation and supervision is going to take considerable time in many emerging markets, and that it is important to look for alternative means of protecting these economies while this objective is achieved. For the reasons explained in the report, I do not believe that narrow banking can be of much use in this connection. Rather, the promotion of foreign investment in the banking sector is indeed an option that has to be sought. I also agree that, in some particular cases, the use of taxes on foreign capital inflows can play a useful temporary role to protect the banking system from the adverse implications of capital flows.

Before turning to the other issues, I would like to note that my Mexican authorities have a number of comments on some of the references to Mexico that appear in the papers. These will be discussed bilaterally with the staff.

In regard to mature financial markets, the turbulence associated with the Asian crisis has not had a significant impact on the industrial countries' financial markets. With the support of a robust macroeconomic position, mature financial markets, with the major exception of Japan, have been characterized by a situation of generalized optimism during the last year: downward trends in interest rates in credit and money markets, a decline in nominal yields in long term public bonds in some cases to historical lows, booming equity markets, and so on.

The central question is of course for how long is this situation likely to continue. The staff identifies five main sources of risk in this connection: the performance of the Japanese yen, the fragilities in emerging markets, the potential for an upswing in interest rates, the sustainability of equity prices, and changes in the structure of global financial markets -in particular the growing role of OTC activity-. I agree with this assessment, and I believe that the most important risk for mature financial markets and in general for the world economy at this stage is related to economic developments in Japan.

It is widely agreed that the main factors behind the decline of the yen are concerns about the weakness of the Japanese economy and the fragile state of its banking system. The papers provide a detailed explanation of the measures that the authorities have adopted to solve the second of these problems. These are steps in the right direction, and I welcome the efforts to strengthen the Deposit Insurance Corporation and to create a financial crisis management fund, to reform the supervisory framework, and to deregulate the financial sector. Nevertheless, the timing involved has been very long, and the process of implementation not fully satisfactory. Markets' interpretation of the reasons for the long delays observed in dealing with the problems of the financial sector in Japan also gives rise to concern. On the other, hand, it is evident that these efforts by themselves will be insufficient to overcome the problems faced. The recovery of economic activity is another essential precondition, and the prospects in this front are not very clear yet.

Finally, let me make some comments on EMU on behalf of my Spanish authorities. They are convinced that EMU has been and will continue to be a crucial element in the financial and economic transformation of Europe. Some of the benefits from this transformation are already evident, for instance in bank concentration, an improved allocation of resources toward the most efficient markets, the generalized adoption of cost-saving measures, and the diversification of activities to take advantage of synergies. My authorities agree with the staff that this process entails a number of risks. They believe that while these risks must not be disregarded, it is also important to take into account other factors in the analysis. The strengthening of the financial systems resulting from the absorption of weaker institutions by sounder ones during the process of European integration is a case in point. The vast experience and prestige of national supervisors is another. On the other hand, my Spanish authorities consider that the emergence of coordination problems in the event of a liquidity crisis is unlikely, and they would like to stress that approaches to crisis management within the EMU are under discussion, and that a process of increasing coordination and exchange of information among financial authorities is already under way. Finally, on the issue of the TARGET payments system, while my authorities are convinced that this is the best option to minimize systemic risks in cross-border transactions, they agree with the staff that there are some areas where there is room for improvement, such as the policy of full cost recovery. They expect, however, that as experience is gained, the required adjustments will be made to the system to cover the major areas of concern.

Mr. Wijnholds made the following statement:

The report contains as usual an interesting set of topics that are central to current developments in the international money and capital markets. Unfortunately, since the issuing of last year's International Capital Markets report, the Asian crisis, which began in mid 1997 in Thailand, has deepened further, has spread to other countries, and has even had some impact on mature capital markets. It is undoubtedly the most important financial event of the past several years. I therefore endorse the choice of topics for this year's International Capital Markets report and the emphasis placed on the analysis of the Asian crisis and its effects on world capital markets and especially the financial policy lessons that can be learned from the current crisis and from past ones. I also appreciate the emphasis placed in chapter 5 on EMU and on banking and prudential regulations. While I am impressed by the high quality of the staff's work, I would have appreciated a somewhat more concise report with some of the more technical issues moved to appendices.

Let me add in the vein of constructive comment that while I found the references to the literature useful and interesting, it is striking that they are overwhelmingly from Anglo-American sources. Practically no reference is based on Continental European contributions and little use is made of official sources (except for descriptive references). No doubt, the majority of high quality economic literature is published in American and British journals, but there are still some worthwhile contributions elsewhere, including in official publications, for instance those of the Deutsche Bundesbank (also available in English).

I will focus my comments to the following issues: moral hazard and financial aid packages, capital controls, incomplete information and prudential regulations, and financial supervision in Japan.

In regard to moral hazard and financial aid packages, the staff notes in the introduction and in Chapter 3 that there is no evidence that private capital flows to Asia were based on the expectation of a bailout package and that there is little evidence on the extent to which moral hazard has influenced the structure and pricing of capital flows to Asia. I agree with staff that the initial capital inflows that preceded the crisis in Asia were probably based more on the assumption that the Asian countries were "star performers" who would continue their strong performance. I also agree that the moral hazard effects on the inflows and the pricing of risks in the period prior to the crisis were probably related to the history of generous support to financial institutions and the markets' observation that few, if any, financial institutions were ever allowed to go under. It would therefore be exaggerated to conclude that the markets were initially mainly motivated by the assumption that the economies would be bailed out by the IMF and other multilateral lenders, although the Mexican crisis may have established some hopes, rather than expectations of such operations. Nevertheless, it seems to me that the potential moral hazard effects of the financial rescue packages in the aftermath of the crisis are far from negligible and it would be a mistake to ignore them. The three governments of the most severely hit countries had provided after the crisis, in some way or another, unwarranted guarantees to the financial institutions which provided indirect guarantees to the foreign creditors. Thus, eventually the governments had acted as, presumably, expected by the markets, as the worst case scenario turned out to be a promise by the government to bail out the institutions. It was at this stage that the Fund came in with its rescue package which was provided to the governments but in effect endorsed the governments' guarantees to the financial institutions and this may indeed have a significant effect on the future behavior of investors.

Regarding the search for empirical evidence on the existence of moral hazard, we should not be the least surprised that no hard evidence was found because, almost by definition, such evidence cannot be found ex post in cases when we cannot separate the effect of moral hazard on the behavior of creditors from the effect of other factors, such as the arrival of new information. The fact that creditors continued to reduce their exposure to the crisis countries even after the announcement of the rescue packages does not necessarily imply that the effect of moral hazard is negligible but rather that this behavior could be the result of several conflicting factors: a major reallocation of the creditors' portfolios due to a reassessment of the risks, which takes some time, and an opposite effect of the assurances given via the rescue package. I also contest the way the hypothesis is presented, namely the initial assumption is that there are no moral hazard effects and it has to be proven that moral hazard indeed exists. The empirical evidence could be interpreted as lack of evidence that there are no moral hazard effects. Such an interpretation will eliminate or at least reduce the tendency to ignore the effect of the rescue packages on the future behavior of the markets.

To avoid any misunderstanding, let me emphasize that I do not argue that the Fund should have refrained from providing very large credits to three East Asian countries and to Russia. While there is to my mind clearly moral hazard involved in these rescue operations, I did not at the time and do not now see a workable alternative to the way the Fund acted in these cases under the prevailing circumstances . (However, I do believe that we were late in involving the private sector in the case of Korea and am not impressed at the way this was done in the Russian case). The cost of not providing the credits in the crisis atmosphere that existed would in my view have been greater than the cost in terms of moral hazard. I, therefore supported those transactions. However, the probability that considerable moral hazard is involved, which could encourage future incautious cross border investments and loans to emerging economies, makes it imperative that we try to minimize the moral hazard. The general manner in which this should be attempted was endorsed by the Interim Committee in its April meeting, namely by involving the private sector at an early stage. In this way a more balanced burden sharing between the public and private sector, and among private sector participants, can be brought about.

As regards capital controls and the imposition of taxes on short-term inflows, I agree with staff that policies designed to curb short term capital inflows may be effective in the short term but tend to lose their grip over longer periods of time. Annex 4 reveals that there is little evidence regarding whether Chilean type controls have been effective in reducing the accumulation of short term external debt. I especially found striking the large discrepancy between Chilean national debt data and BIS data regarding the maturity composition of bank borrowing. It also seems that, as in other countries that had imposed capital controls, the private sector almost always finds ways to circumvent the regulations and is engaged in a "cat and mouse" kind of game with the authorities. I certainly agree with the views of some of the authors quoted in Annex 4 that attribute the success of the Chilean authorities in stabilizing the financial system to strong prudential regulations rather than to capital controls. It would therefore be a mistake to adopt Chilean type capital controls and to expect them to perform miracles without also adopting the Chilean well designed prudential regulations. It also appears that in order for Chilean type controls to be maximally effective, at least for a while, they need to be applied across the Board on all inflows, including some non-debt creating inflows such as investment in equity in the secondary market (otherwise such inflows can be turned into short term debt through the use of derivatives). Otherwise, if one wants to be a bit more selective in the implementation of the reserve requirements on inflows the system needs to be backed up by restrictions on capital outflows as well, as in the Croatian model.

It would have been useful if the recent reduction in the rate of unremunerated reserve requirement from 30 to 10 percent in Chili receive appropriate attention in the text (it is now only mentioned in a footnote). It is my understanding that the reserve requirements were reduced in view of

Chile's current account deficit and the overall decrease in capital inflows to emerging economies. However, the original idea behind the reserve requirements was to affect the composition of the capital inflows but not their total level, and if this is indeed the case why should they be lowered?

Turning to incomplete information and prudential regulations, there is some anecdotal evidence suggesting that incomplete information on the part of creditor banks did not play a major role in the Asian crisis. During interviews held with large, internationally active Dutch banks, they indicated that while information on a country's usable reserves as well as more accurate information on short term debt obligations could have been useful, access to such information prior to the crisis would probably not have changed their lending activities in Asia. These findings were confirmed by other G-10 countries (a Eurocurrency Standing Committee fact finding group on the use of information and risk management by international banks). It seems that banks preferred to go through with a transaction in a high-risk country which has a high probability of a loss rather than to lose market share by not participating in the deal and perhaps foregoing future potential transactions. If this kind of market psychology was one of the driving forces behind the Asian crisis then improvement in information per se, however important it is, would not have sufficed to prevent the huge capital inflows that preceded the crisis. A strengthening of (creditor) banking supervision, i.e. setting higher capital ratios on (short term) interbank loans, as suggested in the staff report, could therefore be beneficial. I would, however, prefer that the implementation of this stricter supervisory regulation be carried out in an international context, e.g. by the Basle Committee on Banking Supervision.

There are some positive developments indicating that banks are attempting to improve their risk assessments and apply them to their loan portfolio. Until very recently, country risks were usually not expressed in terms of higher prices (spreads), but rather in quantities, i.e. by setting credit limits, because creditor banks perceived themselves as being price-takers in a competitive environment and were reluctant to require a higher risk premium that would make them less competitive. There are now some indications that creditor banks are beginning to set up a system where required returns on loans are based on the country's risk assessment.

Additional discipline should also be imposed on debtor banks. As the staff report suggests, capital requirements on the short term foreign currency denominated liabilities of banks could also be increased. However, I believe that, other than suggested in the staff report, these capital requirements should not only be imposed in the case of a fixed exchange rate regime, but irrespective of the exchange rate regime of the debtor country, as borrowing (and lending) in foreign currencies bears risks by definition, and these risks are non-diversifiable and of a systemic nature.

In regard to financial supervision in Japan, I welcome the establishment of Japan's new financial watchdog, the Financial Supervision Agency (FSA). However, given the complexity of its mission, the agency seems to be understaffed (only 68 persons in the Supervision Department). As sound supervision is indispensable for credible and successful financial sector reform, the FSA probably requires a much larger staff and budget. The FSA should be able to recruit scarce supervision talent (possibly from outside of Japan) with competitive pay packages, and to have the means for training inspectors.

Concerns about the adequacy of supervision capacity have gained additional weight in light of recent reports that Japanese banks have been very active in the market for credit derivatives (default swaps) in the past year. The weaker banks may have been more willing to offer these guarantees because they needed the associated fee income to prop up their cash flows. Substantial additional credit exposure may thus be hidden in off-balance sheet items, which complicates the evaluation of the soundness of financial institutions by supervisors.

Concerning miscellaneous issues, Box 1:1 on page 2 on improving the international architecture is very helpful. However, the bullet on the role of the private sector and public policy is too non-committal. "The potential involvement of the private sector .... is being studied." In fact, the Interim Committee requested the Board "...to intensify the consideration of possible steps to strengthen private sector involvement."

On page 4, fourth line, it is mentioned that by early 1997, some market participants were feeling growing concerns about the narrowing of spreads. There were also officials who as earlier as that, and in fact earlier, expressed such concerns (also at our WEMD sessions as I clearly recall).

On page 11, "herding behavior" is described as being typically the most important factor when there are deficiencies of information. However, as I indicated in the foregoing, there seems to be a more deep-seated problem caused by competitive pressures and the desire for increasing or at least maintaining market shares.

On page 11, the last sentence notes that it is generally recognized that international support would affect only a limited number of creditors etc. I am not so sure about this general recognition. There may well also be a perception that the Fund is willing to take on all cases and help bring together financial packages covering all of the countries' financing needs if they are thought to have a systemic or important regional impact. Greater and earlier private sector involvement is called for to address this problem.

Table 1 on p. 46 of the annexes paper presents the proportion of short-term debt of the banks. However, the share of short-term debt does not always provide a good indication of the potential for capital inflows because banks have sources other than borrowing from foreign banks. For example, in the case of Israel, the share of short-term debt is low but the amount of foreign currency denominated loans is large and has increased substantially in recent years.

Mrs. Guti made the following statement:

The staff is to be commended for the depth and clarity of this report, and for the effort made to present objective and balanced assessments of trends and the policy challenges to be met. As is evident from the report, economic weakness in Japan and the accompanying pressures on the yen have added a new, and potentially volatile dimension to the fragile situation in Asia, raising the prospect of further economic contraction in the crisis countries in that region and possible broadening of the crisis, especially to emerging countries in other regions. Already, these other emerging countries are facing increasing pressures from the tightening of conditions in capital markets in the ongoing re-evaluation of emerging market risks, and many are having to make difficult adjustments in the face of the decline in commodity prices. The report also points to the possibility of more significant spillover effects on the mature markets of North America and Western Europe in the event that efforts by Japan to address the weaknesses in the banking system and stimulate recovery proved ineffective. Barring such a setback, the risks posed by a correction in equity values in these markets may well be easily manageable. Asia, in our view, remains the major concern and I believe that the resolution of the crisis there requires strong effort by the individual countries, but with broad and continued involvement of the international financial community. Let me turn attention to the issues listed for discussion.

On risks and uncertainties that may be facing the international capital markets, staff have examined the main areas that have been of concern to market participants and policy makers alike. Evidently, the financial and economic situation in Asia remains fraught with pitfalls. It seems likely that if growth weakens further in Japan and the yen suffers further sharp depreciation, stability of the region would be seriously jeopardized. Such a development could only make the situation worse in the crisis countries, where the need to reverse the sharp contraction in output and reduce unemployment is pressing. I believe the probability of such a deterioration serves to underscore the urgency that needs to be attached to the implementation of the ongoing reforms aimed at addressing the structural weaknesses, especially in the financial systems in Japan and the crisis countries. Staff have also drawn attention to the fact that the re-evaluation of emerging market risks which followed in the wake of the Asian crisis is continuing. Accordingly they see a worsening of the terms and conditions of external financing, which could put additional pressure on the more vulnerable emerging countries and lead to renewed currency pressures. This has to viewed this with serious concern because, with the crisis still evolving, it is more than likely that investors will tighten conditions more than is warranted by underlying economic fundamentals. As regards equity price corrections in the mature markets, domestic economic conditions in many of the countries would suggest that they could weather a major correction unless these are amplified by external developments such as a serious deterioration in Asia. It seems reasonable to expect that a successful correction may not have a lasting adverse impact on the emerging markets.

Turning to the lessons that could be drawn from the Asian crisis for financial reform and capital account liberalization, two appear to stand out from this report. First, there is a strong suggestion that it is necessary to have an effective regulatory and supervisory system in place in order to provide financial institutions the ability and the incentive to price and manage risks including those associated with volatile capital flows. The evidence in several of the emerging countries appears to show that the lack of such regulation and supervision following financial liberalization, led to imprudent lending, weak balance sheets and the carrying of large unhedged interest rate and exchange rate exposures by banks. The second, based on the recognition that it takes time to strengthen the financial sector, suggests that the opening up of a financial system needs to be an orderly process, during which temporary measures in the form of prudential controls, may be taken to restrain certain types of capital inflows.

As regards the factors that account for the sharp depreciations during the Asian crisis, one can say with hindsight, that unsound practices by the banking system especially those involving foreign exposures by banks and also the nonbank corporate sector contributed in aggravating the crisis. Also, the initial policy response by the authorities was hesitant in part because, they, like most others, did not fully appreciate that the combination of factors would result in a severe crisis such as eventually unfolded. The Asian experience, in contrast with the successful defense mounted in other emerging countries, seems to lend important support to the necessity of an appropriately tight monetary policy to prevent the free-fall of the exchange rate. It also underscores the danger posed in such situations, by large volumes of un-hedged foreign currency debts. However, as many would admit, the decision which confronted the crisis countries in Asia was a difficult one, involving a trade-off between resisting excessive depreciation on the one hand, and the need to guard against the damage to the weak financial system and a highly leveraged nonbank sector, on the other. These countries continue to face this trade-off which has in some ways become more difficult, with the larger than expected contraction in output.

On the issue of surges of capital inflows, I note that staff examined a number of ideas but came to the conclusion that the reasons for their occurrence are not entirely clear. It seems to me that the search for higher returns, as margins narrowed in the mature markets, due in part to the cyclical position of the economies of Western Europe, played an important part. The role of herding behavior also cannot be excluded and one wonders whether the return flow of capital to the asset markets in North America and Western Europe may not be creating a situation that could give rise to imprudent investments, and therefore sowing the seeds of another crisis.

As to how the size of swings in capital flows could be mitigated, I believe much depends on how much is learnt from the present crisis. As shown in the report, the three emerging market crises that have occurred since the 1980s share a number of similarities. Among these, two are worth noting in this regard : first, in all three crises, borrowers maintained substantial unhedged exposures to foreign exchange developments; and second, the emerging countries had made a transition from highly restrictive financial regimes to open regimes but without a corresponding development of the risk management skills and appropriate regulatory and supervisory systems. Hopefully, as the weaknesses in banking systems are addressed, future crisis, when they occur, would be less severe. A major challenge, therefore, is that of strengthening the financial system. Here I agree with staff on the importance of effective market discipline to ensure that management and owners have an incentive to maintain the health of their institutions. For emerging countries, in particular, the challenges ahead are difficult, complicated by the growth of off-balance sheet exposures and the data problems involved in tracking new types of exposures. Meeting the challenge of strengthening the financial sector will inevitably be a gradual process and, in that context, as noted earlier, temporary measures to restrain certain types of capital flows will play a useful role.

Regarding cross-border interbank lending, the report makes clear that the Asian carry trade, in which investment banks and international money center commercial banks were large players, was an important factor in deepening the crisis. Some features of this activity are worth noting: first, inflows which were initially invested in sovereign credit, later found their way into the entire range of money market instruments, as well as obligations of the corporate sector. Second, due diligence on the part of the international lenders was anchored on implicit and explicit guarantees offered by the authorities on exchange rate policy and the domestic banking system. Thirdly, most of the activity bypassed collectors of official statistics and this led to uncertainty with regard to the external liabilities of domestic residents. From these, it is clear that the carry-trade was open to serious risks of moral hazard. It also lacked transparency and effective monitoring and was susceptible to the weaknesses of what turned out to be the inadequately regulated and supervised banking system. This suggests the need for strengthened supervision and regulation, as well as improved monitoring and transparency as priorities for reform in those countries. It also calls for close monitoring and regulation of the activities of the money center lending institutions.

Mr. Yoshimura and Mr. Ono submitted the following statement:

First of all, I would like to commend the staff for again providing us with an ambitious and comprehensive staff paper on recent developments in international capital markets. This paper focuses appropriately on current issues of international capital markets, particularly on the emergence of the Asian crisis, the responses to it, and on establishing a new architecture for the international monetary system. On the other hand, as many Executive Directors mentioned last year, I think that the staff paper could have been more concise by focusing more on analysis and the policy implications of recent developments and less on the descriptive portion.

As regards the Asian currency crisis, since the currency crisis first occurred in Thailand last year, there is no doubt that issues related to the Asian crisis, including contagion of the crisis in the region and the impact on the world economy, have been the main focus in international capital markets. The Asian countries suffering from the crisis have implemented macroeconomic adjustment policies and structural reforms based on the programs supported by the Fund. However, many challenges remain before these countries return to a sustainable growth path. And it seems that there have been differences among them in terms of the progress of structural adjustment and restoring market confidence. Moreover, the turbulence in emerging markets has not yet been addressed completely, and we cannot deny the risk of further contagion to other emerging market countries.

In order to address these uncertainties surrounding emerging markets, it is necessary that the affected countries continue to implement adjustment policies steadily in line with the program. It would be adequate for each country to implement tight macroeconomic policies and structural reforms in order to address its own problems. However, when countries with deep economic linkage simultaneously take a tight stance on macroeconomic policies, the mutual reinforcement could result in a deflationary impact on regional and world economies as a whole. We should always be cautious of this potential risk from a regional and global perspective.

As a new lesson from recent events, we can point to the importance of maintaining political and social stability and promoting a social consensus in order to reap the benefits of economic adjustment policies. In this respect, it is encouraging that those countries suffering from the Asian crisis have fine-tuned their programs, following reviews. We should keep in mind that it is important to pay attention to targeting well the social safety nets for the poor, who will be most severely affected by adjustment policies.

This ICM paper unfortunately provides little space as to how the Fund has performed during the Asian crisis. As the Fund has played a major role in tackling the current crisis, readers might get the impression that the ICM paper does not analyze the Asian crisis in a well-balanced way. I recognize that it is difficult at this point to incorporate assessments on the Fund's role in this crisis, and that we will have a chance to have intensive discussions on this issue over the coming months. Nevertheless, we cannot deny the need to review critically the achievements and failures of the Fund programs in addressing the Asian crisis. As I said in our previous discussions on the Fund's external communications policy, the Fund should try to learn as much as possible from what outside critics say about it. The concerns that are often pointed out about the Fund programs, though not exclusively, could be listed as:

In the context of economic contractions after the emergence of the crisis, the tight fiscal stance that was adopted at the beginning of the programs could further facilitate economic contractions leading to reduced confidence in the economy;

the significant tightening of monetary policy with the objective of maintaining exchange rates could result in destabilization of the financial sector, and facilitate further depreciation, despite the initial purpose; and

a rapid shift from the exchange peg system to the floating system could weaken confidence in the currency and lead to significant capital flight, including local capital, which would result in a further free fall of the exchange rates. It might rather have been considered to allow for considerable depreciation and then pursue maintaining the exchange rates at that level.

There are also some questions raised relating to crisis management:

While contagion was avoided in the case of the Tequila crisis, why could it not be contained in the Asian crisis?

In the case of Indonesia, which agreed to the Fund program before significant losses of reserves occurred, why, then, did the problems deepen further and contagion over-extend to the region even after the program began?

Regarding Thailand, could more up-front and decisive international support enhance international credibility and avoid contagion spreading to other countries?

It is not my intention to discuss these points today; however, I hope that a constructive and comprehensive discussion at the forthcoming Board meeting will address various related issues, including these points.

I would like to add some comments on a few lessons learned from the Asian crisis that could be discussed separately from the context of the Fund programs in the crisis.

First, an important lesson is the issue of how to address the possible adverse impact caused by rapid and volatile capital movements. Needless to say, no one denies that the liberalization of capital movements will be beneficial to the world economy over the long term. However, it could be said that we have primarily focused on long-term benefits from capital liberalization, and shed less light on its adverse impact on economies. As the Asian crisis has reminded us, we cannot deny the potential detrimental impact of volatile capital movements. In this context, the liberalization of capital movements should proceed at an appropriate pace and with proper sequencing in order to minimize such volatility in capital movements.

Second, we can point out the critical role of the vulnerability of domestic financial system in the emergence of the crisis. In other words, a fragile financial sector could weaken market confidence and accelerate outflows of foreign capital, which could result in a crisis, even though an appropriate macroeconomic policy accompanied by relatively sound economic fundamentals has been implemented. Regarding this, the staff accurately noted a significant difference in background conditions between the Tequila crisis and the Asian crisis. It could also be noted that since Asian countries have become highly dependent on indirect financing because of undeveloped domestic capital markets, the already weak banking sector had to carry the considerable burden caused by rapid capital movements. Moreover, the crisis has been exacerbated as the real burden in the financial and corporate sector of servicing large, unhedged, foreign currency denominated borrows increased as a result of the currency depreciation.

This vulnerability of the financial sector needs to be resolved promptly in light of the sector's important role in supporting economic activity. We agree with the staff's suggestion that taking measures to improve the soundness of the local financial system is important. In order to minimize the adverse impact of rapid and volatile capital movements, it is crucial to take decisive actions, including strengthening transparency and disclosure, improving banking supervision and regulation, and letting market discipline work sufficiently. Similarly, effective steps must be taken to promote the development of local capital markets, including bond markets, so as to facilitate direct financing, although it might take a somewhat longer time to complete this process.

Having said that, we also need to be aware that it takes due time to bear the fruits of strengthening the financial sector. Indeed, it could be argued that the liberalization of capital movements outfaced the process of strengthening domestic financial systems, which would be one of the reasons for the current Asian crisis. Against this background, it is worth considering the introduction and strengthening of prudential regulations in countries that have been in transition and are attempting to strengthen their domestic financial systems. In this connection, we appreciate the useful analysis by the staff in the background paper, which sheds light on the pros and cons of a cross-border Chilean-type "tax" on short-term capital inflows. At the same time, we must keep in mind that these prudential regulations are not substitutes for, but supplement, prudent macroeconomic policy and the strengthening of the financial sector.

On exchange policy, I agree that greater flexibility of exchange rates is helpful in some cases in dealing with rapid capital movements. However, an implication of the current turmoil in Asian markets is that a mechanism for accelerating devaluations could function in the sense that depreciation of one currency places depreciation pressure on other currencies in terms of maintaining competitiveness. In order to prevent such an increase in devaluation pressure, I think that it might be useful for countries whose currencies have maintained a close linkage with the U.S. dollar to pursue a new anchor rather than adopting a completely flexible exchange rate. The staff's comments regarding this point would be appreciated.

Finally, this paper provides some analysis on measures for addressing the financial sector problems in developing economies, which include narrow banking. Although this is certainly an interesting theme to be discussed, we must be aware that it is difficult for developing economies, in practice, to adopt such a radical measure as narrow banking at this moment. Further analysis on this subject is encouraged.

Turning to mature financial markets, this ICM paper points out that it is a major risk in international capital markets whether Japan is able to deal promptly and more forcefully with its banking and financial sector problems. It is welcome that higher attention from a global perspective has been paid to Japan's financial system and capital markets. Having said that, I would like to stress here that my authorities are well aware of the global importance of the

Japanese financial sector, not only for our own economy, but also for the global economy as a whole, and that they already have taken various steps in this regard, including acceleration of the financial sector restructuring with the use of public funds, introduction of strict measures based on Prompt Corrective Action, improvement of transparency and disclosure, the introduction of a Bridge Bank for failed banks, and facilitation of the securitization of real assets. A new prime minister has been elected by the Diet on July 30, and he has indicated that a new administration would pursue its best efforts to completely resolve the financial sector problems. I believe that the financial sector problems will be addressed promptly with strong political determination, and that this will contribute to the world economy as well.

The development of the U.S. economy is also a key for the development of the international capital markets in the period ahead. As a major economy with a key currency, the U.S. economy has always been encouraged to play a major role in maintaining stable international capital markets and promoting sustainable world economic growth. Also, it should be noted that the current crisis was triggered by the significant depreciation of currencies with close linkage to the U.S. dollar. In other words, a strong U.S. dollar could be a factor in the crisis. Although the macroeconomic management of each country should mainly take into account its own domestic economic situation, I encourage the United States to fully recognize the important role of its economy and its currency for the world economy, and to continue appropriate economic management with a global perspective.

One of the most remarkable phenomena in the mature financial markets is that long-term interest rates have globally declined. This phenomenon is itself a good sign in supporting world economic growth. However, it is partly attributable to an exogenous factor, namely large capital flight from the Asian countries affected by the crisis to mature financial markets. I am concerned about whether there is excessive optimistic expectation in favor of mature capital markets. If this expectation accelerates, an increase in uncertainties in mature financial markets for some reason may cause a drastic correction in the markets. Those potential risks should continue to be monitored cautiously.

Regarding EMU, it is encouraging to see the positive reaction of the markets to the progress of the preparation for EMU, such as the announcement of participating countries to EMU from the beginning of 1999, and establishment of the ECB. However, I have one concern regarding the division of labor between the ECB and the central banks of individual member countries. According to the staff paper, each central bank has the responsibility for financial supervision and the role of lender of last resort within its own country. Each central bank can surely take prompt and decisive actions in reacting to turmoil within domestic capital markets. However, if the turmoil goes beyond one country and expands throughout the region, it might be difficult to deal with it by depending only on each central bank's reaction. As pan-European capital markets are developed, an institution that has the role of the LOLR for pan-European capital markets as a whole, or a role of coordination among central banks, will be needed to ensure the stability of pan-European capital markets. I think the ECB should assume these roles and I would like to hear the opinions of other Executive Directors on this.

Mrs. Sein and Mr. Zubir submitted the following statement:

We commend staff for their preparation of this very informative report. The amount of extensive research and fieldwork done in obtaining the insights of market participants and country authorities are evident. Clearly a major challenge for the staff was how to focus on the major themes emerging from the voluminous amount of information gathered. The numerous boxes, tables and charts have helped. However, staff may also want to consider streamlining certain chapters to make the main report more focussed. In particular, the first two sections of Chapter II, as well as the first four sections in Chapter IV provides essentially background information, and they could be more suitably located in the Annexes.

Turning to the contents of the report itself, the paper has certainly added new insights on the Asian crisis from the perspective of the financial markets. We like to share our views on certain aspects of the report.

We share the views of Messrs. Sivaraman and Jadhav that, with regards to the Asian crisis, the report "seems to place a disproportionately large share of the blame on the borrowers (and their policy makers) while letting the creditors off the hook rather lightly". It has to be acknowledged that financial markets are not infallible. The economic boom in East Asia has been underway for slightly more than a decade, and the economies in the region had been extensively dissected and studied by academics, international organizations, policy-makers as well as market researchers. The structural rigidities, economic policy framework and corporate practices in these economies are well-known. Financial market players are aware of these information, and the more prudent ones would have given more careful consideration to these factors. However, for most market players, while aware, their decision to enter has been largely motivated by the promise and evidence of better returns than in mature markets, and the desire not to be left out of "the big game" in Asia. The bottom line is, providers of short-term capital have gone in with their eyes fully open, aware of the risks but lured by the profits. At the emergence of threat to their profit margins, they have rapidly exited these markets, citing the lack of transparency and governance in these markets. We do agree on the need for greater transparency and better governance. However, the onus does not only lie on the users of capital and their policy-makers, but also on the providers of capital as well. In an increasingly globalized and integrated world economy, we do see a growing need for a more systematic and transparent system of monitoring the increasingly large and volatile flows of capital in financial markets. In the event of a crisis, the private sector, and in particular creditors, clearly do have a role to play in the stabilization efforts by ensuring that there is no liquidity crunch in the affected economies.

Box II.13 highlights the present inadequacies of credit rating agencies. By the nature of their function, these institutions are expected to be independent and forward looking in their assessment of risks. However, during the Asian and past crises, they have largely proven to be reactive to events and have thereby on several occasions exacerbated the volatility in affected financial markets. It is troubling to realize that while the reports and ratings of credit rating agencies have tremendous influence on investors' decisions and hence capital flows, these institutions are not subject to the prudential oversight of a central supervisory body, nor are they required to conform to a code of best practices. As we are in the process of constructing a new architecture for the international monetary system, it would be prudent to re-examine the role of key players in the financial markets.

In Boxes II.1 and II.3, staff appears to present a contradictory message on the resilience of foreign direct investment (FDI) during a financial crisis. Box II.1 indicates that inflows of FDI into the affected Asian crisis have remained largely unaffected during the Asian crisis. This have been borne out by anecdotal evidence and regional press reports of the continued confidence of foreign investors, in the manufacturing and services sectors, of the long-term potential of the region. Box II.3, however, sets out to dismiss such resilience as a myth. The arguments set out by staff appears plausible and should be examined further. If proven valid, the implications for growth policy prescriptions as well as prevention of financial crises for emerging economies are significant and should not be summarily overlooked.

The Asian crisis has added fresh perspectives to the ongoing debate on capital controls and capital account liberalization. The crisis has also exposed the limited understanding that authorities and regulatory bodies have on the new market dynamics produced by the trend towards greater capital account liberalization and the global integration of financial markets. For now, our view remains that an economy should not completely open its capital account until it has sufficiently strengthen its domestic financial sector, as well as its regulatory and supervisory capabilities. We do feel there is scope for some form of capital controls to help better regulate the magnitude and volatility of capital inflows. The challenge would be to ensure that such controls do not create market distortions, and that they are readily removed when it is apparent such controls are no longer needed.

The experiences and degree of success of the various emerging economies in defending their exchange rate regimes during the Asian crisis makes for very sobering reading. It is evident that in the new financial environment, the debate over the appropriateness of a pegged vis-a-vis a floating exchange rate regime has grown more complicated then initially realized. It is thus important that staff do not advocate a "one-size-fits-all" kind of exchange rate policy prescription in discussions with country authorities, and in particular for program countries.

Finally, the report has several extensive references to the countries in our constituency, and we have referred the paper to our authorities for their feedback. We will be discussing the comments from our authorities bilaterally with the staff.

Mr. Palei made the following statement:

The paper on International Capital Markets is destined to become one of the most visible of the Fund's recent contributions to the ongoing public debate on the lessons of the Asian crisis. The material presented to the Board adds a crucial empirical dimension to the analysis of the Asian crisis. It is one of the few recent attempts to analyse a large group of affected countries through a prism of the Fund's current understanding of the mechanism of the crisis. I praise the staff for the high quality of the documents presented to the Board. I believe that, since, after publication, this report inevitably will be scrutinized by outside critics and supporters of the Fund alike, the report could be revised and improved in light of the Board's discussion. Hence, I will limit my comments to a few areas where I see room for refinement.

In the Asian crisis, one of the key determinants of financial flows was the apparent inability of the markets to differentiate between the affected countries. In fact, if one ignores the lag in Korea's joining the Asia-5 group, until very recently the exchange rate paths in the affected countries had been closely correlated, a clear demonstration of the failure of the markets to understand the structural differences between the economies and the extent of their vulnerability to the excessive depreciation of the exchange rates. It appears that, as the dominant source of expert opinion on the situation in the affected countries, the Fund could do more to alleviate this market failure. Facilitation of faster recognition of the strengths and weaknesses of these IMF members should be one of the Fund's primary responsibilities. The Fund does have sufficient expertise clearly to express its opinion and to point to some of the key systemic features of the particular countries that affect the degree of structural resiliency to currency pressures. In this report on International Capital Markets there is still room for sharper focus on the differences between the countries.

References to Malaysia in the report on International Capital Markets represent a good illustration of my previous point. Malaysia is included in a group of "affected countries", as defined in the report. As a part of this group, Malaysia is casually and repeatedly mentioned in this report among the countries where the foreign debt has not been hedged and the costs of restructuring of the banking system are likely to be very high. At the same time, I recall the Article IV Board discussion on Malaysia when the staff had specifically pointed to the fact that most of the foreign liabilities in Malaysia were hedged and that the costs of bank restructuring were likely to be much lower than market expectations. My general belief is that provision of accurate relevant information on specific economies could seriously affect market perceptions regarding particular countries and corresponding capital flows.

My understanding is that the staff assign Hong Kong SAR a systemic role in the Asian crisis. Two observations support this view. Firstly, in the report, the attacks on the Hong Kong dollar are often referred to as the beginning of the second severe wave of pressures on the Asian currencies. Secondly, the staff comes up with an interesting analysis of the financial linkages between countries as one of the explanations of the contagion effect.

To illustrate the relevance of this approach the staff describe the links between Hong Kong SAR, Korea, Brazil, and Russia, with Hong Kong SAR being the starting point of the action. If my understanding of the staff's intentions is correct, and they view the role of Hong Kong as systemic, it would be useful to bring this idea forward and explain in more detail why Hong Kong SAR found itself in the centre of the speculative hurricane.

I appreciate the attention paid by the staff to the links between the exchange rate regime and the structural features of an emerging economy. In particular, many observations on the risks associated with the use of nominal anchors provide useful insights into this complex issue and serve as a good outline for further research. The staff identify insufficient hedging by the market participants and an apparent lack of developed instruments and markets for derivative products as some of the pitfalls involved in the use of the pegged exchange rate. In contrast to the staff's view I do not find anything surprising in this situation. In fact, it seems to be the direct result of the use of pegged exchange rate regimes. It is notable that in the countries using the currency board arrangements there is also no motivation for currency risk hedging since it is the government's responsibility.

The answer is not in finding ways to stimulate hedging under the regime of a currency peg, but in the structural strength of the banking sector, promotion of transparency, and the enhancement of the credibility of the exchange rate regime. That is why I commend the staff for their attention to the restructuring of the banking sector in emerging economies. I also agree that the experience of Argentina provides a useful guide for other emerging economies and deserves the extensive description given in Chapter II.

The switch from a pegged exchange rate regime to a floating exchange rate will continue to be at the centre of the ongoing debate on the Asian crisis. On pages 78-79, in the section on the attacks on the Baht, the staff refers to the Fund's advice to the authorities of "an adjustment of the exchange rate" in Spring of 1997. The staff continues by saying that, at this time, "Thailand's foreign exchange reserves ... were still ample to permit a credible defence of an adjusted exchange rate for the baht". Does this passage mean that, before the May attack on the baht and before the overwhelming loss of reserves by the Thai monetary authorities, the Fund advocated a one-time devaluation of the currency as opposed to a switching from the peg to a floating regime? If true, such presentation of the events in Thailand introduces an important dimension to the debate on exit policy and, probably, deserves more prominence in the text.

I welcome the frank discussion in the paper of moral hazard issues. Although the contribution of moral hazard in the correction of the exchange rates is hardly quantifiable, few experts doubt the fact that it did play a significant role in the determination of capital flows to Asia and their subsequent reversal. Similarly, the emphasis on structural nature of the crisis is well placed in the document. The paper makes a persuasive case for the reform of the financial and corporate sectors with an emphasis on transparency, and the introduction and enforcement of clear rules. Moral hazard and structural weaknesses certainly are among the main factors that justify significant corrections of the exchange rates in the affected countries.

At the same time, my impression is that less attention is paid in the paper to the reasons for overshooting in exchange rates. The staff points to such factors as the reluctance of the national authorities to raise interest rates, or their hesitance to take drastic steps with regard to a clean-up of the banking and corporate sectors. Still, there is another rather popular explanation of overshooting as the result of panic and classical runs on the banks. Some of the evidence on the structure and timing of the changes in capital flows described by the staff may support these views. It seems to me that the document prepared by the staff would benefit if they look at the possible contribution of bank runs to the over depreciation of exchange rates and to the observed changes in capital flows.

Finally, I would like once again to praise the staff for their courageous and successful attempt to tackle some of the most controversial issues posed by the recent developments in the international capital markets.

Mr. Szczuka and Mr. Singh submitted the following statement:

The least one can say is that since our last discussion, markets have provided us with ample food for thought for today's meeting. Almost precisely a year ago an unprecedented financial crisis hit a group of countries that had witnessed the strongest growth rates in the past two decades. Not only has the emergence of this crisis in a prosperous and apparently healthy economic environment taken us by surprise, but its severity and its duration are still difficult to fully understand.

The major risks and uncertainties in international capital markets relate primarily to the high valuation levels reached by mature bond and equity markets - at least by historical standards. Another set of risks stem from structural problems in specific countries (e.g. Russia and Japan). If the current financial sector problems and sluggish growth in Japan persist, this could aggravate Asia's economic situation and affect mature markets. In this respect, the "Big Bang" reforms in Japan, and the uncertainty surrounding the ability of Japanese banks to cope with this more competitive environment are additional sources of concern. Whereas valuation problems could - at least partially - be addressed by a gradual and modest increase in interest rates to slow down further stock price appreciations and limit the proliferation of speculative trading strategies, specific difficulties of individual countries will be more difficult to deal with, since fiscal policy and structural measures would be required as well.

As regards the main uncertainties and vulnerabilities of emerging markets, we agree with the staff on the vulnerability of the Asian emerging markets to external developments, especially in Japan and the U.S. If Japan is not able to deal effectively with its problems, a further vicious circle of devaluations, capital outflows and economic contraction could significantly impair the emerging economies in Asia. A drastic reduction in U.S. equity prices could obviously also have damaging effects.

We should not, however, underestimate the risks stemming from the affected countries themselves. Unless very serious reforms are pursued, a deepening and lengthening of the crisis may occur. It is, therefore, urgent for these countries to make all possible efforts to rebuild a functioning, strong and healthy banking system.

Banks' balance sheets should be strengthened. Non-performing loans have to be written off and banks recapitalized. For this purpose, public, as well as, private funds must be used. However, the use of public funds should be made contingent on private shareholders having made their contribution. In addition, the bankruptcy law should be amended to allow banks to seize the collateral of non-performing loans and to strengthen their capital base by selling it. Furthermore, non-viable banks should be closed down.

Regulatory standards should be improved. Critical elements of such regulations are: international accepted accounting rules in order to enhance disclosure and transparency, amendment of the regulations on loan loss provisioning and capital adequacy, as well as, procedural rules that ensure that losses in financial institutions are promptly recognized and borne by shareholders.

Finally, since regulations only make sense if they are effectively implemented, strong supervision must be provided. It is therefore essential for Asian countries to put in place supervisory bodies with the necessary means and expertise to fulfill their duties. Since these reforms need time - particularly the training of specialists - and in order to profit from existing experiences and know-how, the BIS or national supervisors from developed countries should help these countries in improving their banking regulations and their supervisory capacities.

Turning to issues related to capital flows, very large swings in capital movements are a feature of financial worldwide integration. Countries can undertake a number of measures to shelter themselves from the risk of sudden reversals of capital flows. Sound macroeconomic policies must be pursued for instance, as well as efforts to achieve a healthy financial sector. Whenever there are uncertainties regarding the sustainability of macroeconomic policies, a lack of flexibility in the exchange rate will expose countries to speculative attacks. However, countries will not be able to prevent crises from occurring altogether.

The quality and availability of information could be improved to avoid periods of overoptimism on the part of international investors followed by abrupt corrections in their expectations. Fund surveillance of emerging economies - but not only them - must be stepped up and its findings must become more accessible. Without revealing confidential information, which could undermine its future sources of information, the Fund should strive for more candor in its assessment about the state of an economy. Debating findings with other economic observers, such as rating agencies, global banks, universities and international organizations, would assist in improving both information accuracy and dissemination.

Another interesting response could be to introduce controls on short-term capital inflows such as unremunerated reserve requirements. While not being a panacea, such restrictions could be efficiently used as complementary measures to other reforms in the financial sector. The Asian crisis has demonstrated the high volatility of short-term capital, and the vicious circle associated with it. In contrast, FDI has remained surprisingly stable in the region. Well-designed, preferably price-based capital controls could thus protect an economy from being subject to speculative capital movements, which are highly volatile, while not discouraging investors who settle for the longer term. However, as some studies on the Chilean experience tend to show, the effectiveness of such controls declines over time.

The desirability of other components of the Chilean package could be more durable. Limiting the foreign exchange exposure or foreign exchange domestic lending is certainly worthwhile as a prudential measure, even if the banking sector is in good shape. Such restrictions would contribute to preserve the good health of banks, while capital account liberalization is proceeding.

In regard to cross-border interbank lending, interbank loans have accounted for an important share of bank lending to emerging markets in Asia, up to the very onset of the crisis. As other segments of the market, interbank lending did not reflect a full consideration of the risks the banks were taking. Once they were aware of the risks, their sudden withdrawal aggravated the crisis. Besides the overoptimism, banks could expect their claims to be protected by public funds. This moral hazard was reinforced by explicit guarantees of Asian governments.

Ways to involve the private sector in crisis resolutions should therefore be sought. On top of rendering crises less costly for taxpayers, this solution would also decrease the likelihood of crises. In order to minimize disadvantages, we welcome the ideas developed in the staff paper, namely to combine measures involving both debtor and creditor banks. An increase in risk weights could be quite effective if it induced creditor banks to strengthen their risk management system while inciting debtor banks to improve their liquidity management.

Concerning consequences of the EMU, the introduction of the euro will accelerate the ongoing restructuring and consolidation of the EMU banking sector. The main force behind these processes is, however, not the euro but the increasing global competition in the financial services industry and the completion of the single market for financial services. Even without the introduction of the euro, we would see in the near future cross-border mergers and acquisitions and the creation of pan-European banking groups. The question of how to deal with the systemic aspects of this development would thus arise even without EMU.

Yet, the fact that these developments happen at the same time as the start of EMU offers a distinct advantage: with the creation of the European Central Bank an institution will exists that would be well-suited to be at the center of the efforts to deal with the systemic aspects of these developments. It seems, however, that the European Union is not sufficiently seizing this opportunity. The role of the ECB, the sharing of responsibilities between the ECB and the national central banks and the flow of information between the national supervisory bodies and the ECB are still unclear. Given the rapidity with which the European financial markets will change in the coming years, there is an urgent need to clarify these issues.

TARGET, by being a RTGS system, is well positioned to reduce systemic risk related to cross-border payments. It would thus be an unwelcome development should a large part of high-value payments not be sent through TARGET. However, all major TARGET competitors, especially EAF2, comply with the Lamfalussy standards and thus minimize the risks associated with netting schemes. It would thus be premature to preemptively adapt the fee structure of TARGET just to price out competing systems. Some form of competition will be beneficial for users and will certainly not be detrimental to the stability of the financial system, as the example of the United States shows, where Fedwire and CHIPS coexist.

Mr. O'Donnell made the following statement:

I would like to thank staff for producing, once again, an extremely thorough and thoughtful analysis of such a complex and wide ranging set of issues. Both the UK Treasury and the Bank of England have commented that this will become one of their key reference documents.

That said, I do think the sheer volume of material threatens to undermine the impact of the analysis and recommendations. One option might be to separate more clearly the mainly backward-looking discussion of recent developments from the more analytical work. A more radical option would be to reconsider moving to two of these reports a year. This would be clearly justified both by the importance of the issues and the quality of the work. Indeed, it could be argued that the ICM Reports have more value added than the WEO; both are very high quality products, but the former has very few competitors. Perhaps staff and management could comment on the resource implications of semi-annual ICM Reports.

In regard to the major risks and uncertainties in international capital markets, I broadly share the staff's assessment of the major risks in international capital markets, including Japan. I would have added a few risks to the list. Two relating to economic fundamentals, but which could have repercussions for capital markets, would be further falls in commodity prices, and growing protectionist forces significantly reducing the volume of world trade. A "structural" market risk which seemed to be overlooked by the paper is the so called "millennium bug" or year 2000 compliance. It is very difficult to assess the scale of this risk, but there is little doubt that it poses potential dangers in such a technology-intensive market.

On the implications of large equity price corrections in the advanced economies, a sharp equity market correction could create immediate financial stability problems for two reasons: there could be capacity problems in trading and settlement systems; and market intermediaries could face liquidity problems. In these circumstances, market participants' ability to assess risk exposures and adjust market positions are likely to suffer. But a recent G10 Report concluded that in terms of dealing capacity, market liquidity, and the strength of settlement and clearing systems, most countries are in a much better position than at the time of the October 1987 equity price crash.

A large equity price correction could raise more lasting financial stability concerns if the net worth or balance-sheet structure of major market participants was affected. The seriousness of these concerns relates to the extent to which the banking sector is exposed to equity markets, and the adequacy of risk management by financial intermediaries. The G10 Report observes that (i) the participation of non-bank financial intermediaries in equity markets is large and increasing; and (ii) that the exposure of commercial banks although small, has also been rising. Despite these trends, the report concludes that institutions' solvency should not be threatened by anything but the most extreme price movements as modern internal risk management practices, and recent changes to the regulatory regime will act to offset these trends.

There are a variety of mechanisms through which an equity market correction might generate adverse spillovers in the emerging markets: through reduced world growth, and hence reduced demand for emerging market exports; direct contagion to emerging market equity prices—for example, because of a heightened equity risk premium—with negative implications for consumption (via wealth effects) and investment (via Tobin's Q); and a further worsening of the capital position of Japanese banks. The last of these effects—and its second-round effect on the Japanese economy—is potentially the most acute.

The size of these spillovers would depend on the response of monetary policy in the developed economies to an equity price correction. An accommodating response, as after October 1987, would help damp the spillovers onto world growth. It might also induce dollar depreciation (say, if market expectations of future US interest rates were lowered).

As to the impact of EMU on banking and the development of Pan-European capital markets, EMU is a powerful force for change in EU banking, as it will increase price transparency. This will reinforce other and possibly more powerful forces for change, such as increased competition and price transparency, overcapacity in most EU banking markets disintermediation, and technological change. Nevertheless, we have already seen an increase in the pace of consolidation ahead of the introduction of EMU, mainly within national markets (true cross-border mergers are still rare). However, there is a concern that much of the consolidation seen so far has failed to tackle such issues as the reduction of over capacity, and high costs (particularly staff costs) in many European countries.

The single currency will certainly encourage the development of pan-European capital markets, particularly in relation to the money markets and bond markets. Equity markets may retain national features for a little longer (because of the importance of local information), but the recent announcement of the proposed link between the London and Frankfurt stock exchanges shows that the pressures to establish pan-European trading, at least for the larger stocks, will also be very strong.

Turning to crisis management arrangements, the home/host principle—which has been established for many years—makes the allocation of supervisory responsibilities between EU supervisors about as clear as it is possible to make it. There are in fact very few pure "pan-European" banking groups so far; my authorities are aware of only 2 cases (both involving quite small institutions) where a cross-border merger has made it unclear who should be the home supervisor: in both cases the supervisors involved have made special arrangements. It is, of course, quite true that the number of pan-European financial groups could increase as consolidation in the industry proceeds.

Similarly, it is equally clear that lender of last resort (LOLR) assistance, in whatever form is felt to be necessary, is the responsibility of national authorities. The way in which that assistance is provided—whether by central banks, supervisors or Treasuries, and in what form—is therefore similarly a matter for national discretion.

It is quite true, as the staff points out, that the ECB will have the power under the Maastricht treaty in certain situations to prohibit NCBs from providing LOLR assistance. It is also true that the circumstances in which the ECB might seek to prohibit such assistance have not been spelt out. This is partly because, as so often in this area, the laying down of public and binding rules in advance would only serve to encourage moral hazard. In addition, it is generally impossible to anticipate the circumstances in which individual LOLR cases have to be considered.

My authorities do not agree that "the current arrangements between national supervisors and the ECB about the exchange of supervisory information seem inadequate". The key channels of communication are in fact between national supervisors and NCBs (if they are different): and between NCBs and the ECB. But in addition there is a range of extensive and intensive co-operation that also takes place bilaterally and multilaterally, between EU supervisors and EU central banks. The Banking Supervisory Committee (and its associated sub-groups) acts as a advisory council to the ECB, and includes representatives of both supervisors and central banks from all EU countries.

Turning to the target, there is widespread agreement amongst almost all central banks in the developed market economies that real time gross settlement (RTGS) for wholesale payments is a powerful mechanism for reducing systemic risk. With continuous intraday transfers of final funds, RTGS can minimize or eliminate the basic interbank risks in the settlement process. The likelihood of having to absorb unexpected losses or liquidity shortfalls, caused by the failure of a participant to settle its obligations, is greatly reduced. The potentially destabilizing possibility of "unwinding" payments is precluded by RTGS. And settlement pressures are not concentrated at particular points in time (as is the case with a net settlement arrangement), allowing banks more time to cope with problems. When the EU central banks formally committed themselves to introducing RTGS at the national level in 1993; one of the key motivations was to bring the risk-reducing benefits of RTGS outlined above to the cross-border transfer of euros.

As regards the new lessons for financial reform and external capital account liberalization from the Asian financial crisis, my authorities highlight four lessons in particular: (1) the need for the public sector, banks, other financial institutions and corporates to monitor and actively manage their FX exposure; (2) the need for FX exposure limits to be set by the regulatory authorities for individual financial institutions and for their active monitoring and enforcement by the regulatory authorities; (3) the need for the setting of FX limits to take into account the exchange rate regime being pursued; and (4) the need for "stop-gap" measures, given the time it can take to develop resilient financial systems and effective supervisory regimes. These might include: greater international involvement in the banking system; limits on foreign borrowing by banks, other financial institutions and corporates; and limiting the safety net to financial institutions that form the backbone of a country's payment and settlement system.

In regard to taxes on short-term capital inflows, in looking at Chilean-type controls, there seems to be something of an inconsistency between the ICM paper and CAL paper (for discussion on Monday). The former seems to see Chilean-type controls as being effective only temporarily; therefore they can at best buy time, during which the authorities must concentrate on measures to strengthen the financial sector. But the CAL paper seems to be suggesting that there are particular problems with short-term debt which could be mitigated by a holding period tax (along Chilean lines); this is presented as an alternative or supplement to prudential regulation, and presumably therefore as a more permanent policy measure.

I have more sympathy for the former view—that taxes on capital inflows should be seen, at best, as a temporary measure. First, there is the practical consideration that all forms of capital controls tend to become less effective over time; much of the evidence reviewed in the Annex to the main ICM paper is consistent with this. Second, we must avoid giving any credence to the view that taxes on capital inflows are a panacea, or a substitute for sound macro policies and strengthening the financial sector. Indeed, to attribute Chile's success purely to its capital controls would be a disservice to the wider set of reforms Chile has implemented since the mid-1980s, in particular in the area of bank regulation. In this context, I was struck by the fact that, in the early 1980s, before the strengthening of bank regulation, the existence of unremunerated reserve requirements on capital inflows did not prevent a major banking and currency crisis in Chile.

Possible alternative ways of addressing the vulnerabilities associated with volatile capital flows would be: (a) improving the arrangements to shield the most vulnerable members of society from large swings in economic activity; and (b) taking steps to ensure that the risks associated with cross-border interbank lending are properly taken into account.

On cross-border interbank lending, there has been much debate as to the possible distortion in lending banks' behavior resulting from capital weightings which do not adequately reflect the variation in risk associated with short-term lending to banks from different supervisory and regulatory regimes. Had this lending been subject to 100 percent weighting the volumes may well have been lower, although it is less clear that the average duration of such lending would have been longer since creditor banks would still have been wary of providing longer term credits. Proposals to modify the Basle Accord to introduce criteria such as standards of data transparency and the quality of home country supervision in determining risk weights are certainly worth further consideration. But equally important are measures—both in terms of internal risk management and external supervision—to ensure that (I) foreign lending banks do proper credit assessments based on reliable data provided by the debtor country; and (ii) domestic borrowing banks manage their foreign currency liquidity more effectively.

Mr. Milleron made the following statement:

As usual, the work done by staff is very impressive in terms of wealth of information and stimulating approaches. The report identifies two major risks with the potential to affect global capital markets: the persisting weaknesses of the Japanese financial system, and a potential brutal adjustment of the US equity market. I fully share this conclusion.

My comments will be based on the distinction between emerging and mature markets, focusing on the unfolding Asian crisis. I will consider the role of Japan in the context of the unfolding Asian crisis since the Japanese economic and financial situation not only helps provide a better understanding of the crisis, but also will be a key element of the recovery process. Before turning to these issues, I would like to offer some general comments on the globalized capital markets

As regards globalized capital markets, intentionally or not, the staff gives quite an ambiguous account of the global capital markets. It seems clear to me that there still is a fundamental lack of understanding of market behavior(s). Although we are gathering more and more information from market participants, the insufficient knowledge of market strategies largely prevents the authorities and the public from clearly identifying market risks. In addition, the extent to which pure market behaviors—i.e. movements at least partially disconnected from countries' fundamentals and policies— have affected the dynamics of crises is a matter of concern adequately raised by staff. Unpredictable market reactions may lead to vicious circles that, in the case of the East Asian crises, have amplified the adjustment costs and added significantly to the consequences of policy weaknesses.

Among other possible factors, I think that simple "market size" is significant but underemphasized. Relatively narrow foreign exchange markets, in particular, are clearly more vulnerable to rapid changes in liquidity. Thus, they can be subject to extreme bouts of volatility, which can in turn trigger drops in market confidence and, eventually, have an unduly damageable impact on the real economy.

More generally, problems related to different kinds of asymmetries (market size, infrastructure, information, ...) between mature and emerging markets cannot be overlooked when trying to understand their growing inter-linkages that are precisely the characteristic of the current globalized finance. This is for example illustrated in the report through the potential impact of marginal decisions by institutional investors on the total volume of private capital flows to emerging markets. Concerning the ability of international rating agencies to smooth market trends, I basically share the doubts expressed by Mr. Sivaraman.

The central role of information cannot be overstated : problems of data availability, quality, disclosure and analysis are key to emerging market crises both in the phases of mounting vulnerability (indiscriminated capital inflows) and in the amplification of confidence crises (impossibility to distinguish viable from insolvent borrowers). This is even clearer today than five years ago, since global markets involve a growing variety of participants with diverse objectives, time horizons and sensitivities. In the case of the Asian crises, for example, taking into account the widespread role of domestic investors appears essential to a good understanding of market dynamics.

I was also struck by the fact that, despite the availability of ratings on banking systems, markets seemed to have neglected them in their risk management strategies. Although the paper gives us some interesting insights on this issue, I think that further research is needed to understand why markets ignore information, moral hazard certainly being an issue here—but clearly not the only one.

Turning to development and prospects in emerging markets, the staff rightly focus this annual report on the Asian financial markets, including Japan. I can go along with most of the report's analysis, which is probably one of the more complete and stimulating we have had on the subject so far, although, considering the systemic importance of Russia and China, their financial systems would have deserved more substantial developments in the main report. I will limit my comments to some diverging views or additional comments.

In regard to differences and similarities between the Asian crisis and the Mexican crisis, I welcome the staff discussion on the specific features of the most recent emerging market crisis. With some hindsight, it seems that the East Asian crisis—particularly after October 1997— has shown a growing number of characteristics of a full-fledged "global" or "systemic" crisis, particularly as compared to the 1994/95 Mexican crisis. I would only mention two: the drop in private capital flows to crisis countries has not been offset by portfolio reallocations to other emerging areas. 1997 has thus been the first year in the present decade where net capital flows to emerging countries have significantly diminished; and the report rightly illustrates that the current East Asian crisis is more and more closely related to adverse developments occurring in one of the major advanced economies, namely Japan. This indirectly increases its systemic impact on the world economy.

On prospects for recovery and long-term potential, I believe that the Fund could dedicate more efforts to help bring the present crisis into a longer-term perspective. In particular, more emphasis on the fundamental strengths and potentials of the affected countries would contribute to pave the way for a quicker recovery in investor confidence and renewed sustained growth, once the necessary adjustments are carried out. Indeed, there is little doubt that the East Asian countries will continue to offer huge investment opportunities and that a durable deepening of the region's financial markets will follow the present disruptions. Such a potential should, in my view, be more salient in this report.

Along the same lines, in addition to highlighting short-term challenges on emerging markets, more considerations on the recovery factors that have recently developed and that contribute to improving the East Asia region's short-term prospects may have been warranted. Obviously, the crisis is still in full swing in many essential areas, and significant downside risks remain. Nevertheless, several developments do seem to indicate that, one year after the eruption of the crisis, several countries may have turned the corner, and that the uncertainties might now be related more to the timing of the recovery than to its occurrence: export recovery (particularly as for trade with North America or Europe); fiscal fine-tuning (the current reorientation of fiscal policies toward increased support to domestic demand); financial sector restructuring (progress already achieved is significant, and some preliminary signs of growing foreign participation are encouraging); loss of investment grade status by credit rating agencies, which is now behind us.

Concerning spillover effects, I welcome the candid analysis on spillover effects provided by staff: this is obviously an area where further research is required. Although connections among emerging markets through investors' margin calls is a likely channel of contagion, it appears difficult to have reliable information on this matter—the spillover through Korean disinvestment on Brazilian bonds is the only anecdotal information alluded to by the staff on this issue. Trade and competitiveness channels are also not sufficient, although clearly, the once virtuous regional impetus provided by increased trade regionalization (including the central role of Japan) has turned into an adverse aggravating factor. I find the "wake-up call" concept to be quite convincing in the case of the East Asian crisis. Indeed, we must keep in mind that market participants, as well as all other observers, were taken by surprise by the extent and speed of the regional spillover. New types of fundamental weaknesses revealed in the first stages of the crisis have rapidly appeared as key factors of contagion: confronted with "untested" criteria of country risk, international investors quickly and very logically adopted cautious attitudes of retreat from countries presenting the same type of weaknesses. Taking into account the above-mentioned emerging market sensitivity, the unfolding of the regional crisis can then be seen as an almost mechanical development. From this perspective, spillover effects in East Asia are largely linked to the newness of the causes of the crisis, itself a result of the deeper integration of Asian emerging countries in global financial markets.

As to the role of the Fund, although I admit that it is not always appropriate to publicize certain issues, it seems to me that an institution at the heart of a major financial crisis should not ignore the potential interactions between its behavior and markets. Moral hazard is one aspect of this problem which was eloquently raised by Mr. Wijnholds and I agree with him. However, at least for some countries, private sector involvement has been a major and new feature of crisis resolution—although this is certainly less clear in the case of the Russian package. This being said, the interactions between markets and the Fund goes well beyond moral hazard. This is illustrated by the fact that, although financial packages have certainly increased moral hazard, the Fund has had to cope with an unprecedented crisis of confidence. Thus, confidence being a key aspect of crisis resolution, our institution has to seriously assess the credibility of its interventions. There are at least three issues involved, in which a better understanding of market perceptions would be useful: the effectiveness of financial packages, the appropriateness of fiscal and monetary policies, and the emphasis put on structural deficiencies and remedies. Staff comments on these issues will be welcome.

Turning to recent developments and systemic risk in the mature markets, apart from the Japanese banking system, the two main issues raised by the staff are stock market exuberance and systemic risk within ESCB. To be frank, I am not sure that either European markets or European authorities consider that this latter issue merits the same emphasis as the others.

As regards stock market exuberance, there are still considerable uncertainties surrounding the causes for the dramatic increase in equity prices. Last year, the staff provided us with arguments on the optimistic side, in particular the idea that large inflows in 1995-97 corresponded to a new equilibrium in stock markets. This report gives a slightly different picture: it states that there is a potential for a strong reversal, but the corresponding impact is expected to be limited, in particular in the US; at the same time, contagion effects from the US to world markets are difficult to assess but could prove substantial.

I wonder whether the IMF can send such important messages without providing to the public and the markets more thorough analysis of the appropriate valuation of stock markets; otherwise, the Fund might signal that a turnaround in the markets is unavoidable without actually providing any specifications on where this process could eventually stabilize.

Concerning EMU: systemic implications and challenges, the developments contained in the staff report about EMU are a good illustration of the standards approach, recently advocated by the Fund. Basically, the staff is looking at the differences between the European System of Central Banks

(ESCB) model and the "US standard" and asking, implicitly, to fill the gap. In previous years, the same approach was applied to European financial system. Since the staff recently traveled to Europe, I guess that they had discussions on these subjects. Therefore, I expected to see these discussions more reflected in the report (my remark falls in the same category as Mr. Wijnholds's). As this report is going to be released, and is indeed an excellent publication, I am not very pleased with the current approach.

As regards access to TARGET, the basic argument put forward by the staff is the following: if a limited number of transactions are processed through Target, then the system will inadequately deal with systemic risk. I think that this analysis is not convincing and I fully support the arguments put forward by Mr. Kiekens.

On systemic risk management in EMU, the ambiguity of the lender of last resort (LOLR) functions, in EMU or elsewhere, reflects a general consensus within the international community that the role of the LOLR should not be explicitly defined. There are some good reasons for all monetary institutions, including the IMF, to remain ambiguous, in particular because too clear a definition will run counter to the general objective of reducing moral hazard, thus increasing the likelihood of a systemic crisis. For the reasons exposed by Mr. Kiekens, I must say that I am not fully convinced by the staff analysis, which I find, to a certain extent, counterproductive.

First, unintentionally, they are undermining the ESCB organization by focusing public attention on risks that the ESCB authorities are perfectly aware of. The case of cross-border crises has already been identified and dealt with through memoranda of understanding among all EU supervisory authorities, following the adoption of the banking single market. As regards the LOLR function within the ESCB, discussions are well advanced although final decisions are yet to be taken. So far, my authorities have favored a system in which the NCB has a lead role in providing liquidity support; second, they ask the ESCB authorities to disclose internal arrangements which, for the reasons indicated above, they are unwilling to disclose.

As to future issues to be considered, to conclude on this part, I would appreciate it if the next annual report raised two issues:

First, off-shore centers: in a context of globalized markets, the development of off-shore centers is challenging regulations put in place by national and international bodies. I think the time is here to review the development of these centers and to assess the extent of their adverse effects on international monetary and financial systems; and second, money-laundering: if our institution wants to be credible on this matter, some reference to it would be warranted in our international capital markets report.

I would appreciate comments from my colleagues on these proposals.

Concerning procedural matters, on the occasion of the capital markets mission to France, I asked staff whether they would accept my Alternate joining them during their meetings in Paris. They told me they were reluctant to do so, since they have noticed that the presence of the authorities, including from Executive Directors' Offices, tends to reduce the scope of information available to them. I accepted this answer which seems to me to make perfect sense. Nevertheless, this decision becomes less acceptable if not adhered to by all Executive Directors' offices. Therefore, I would suggest that in the future, we agree to mutually abstain from joining staff missions. Comments from my colleagues would be welcome.

Finally, following our recent discussion on transparency, I would suggest that our concluding remarks be published along with the report.

Mr. Al-Turki made the following statement:

The staff has once again provided an extensive and illuminating set of papers on the very important issues relating to the international capital markets. At 342 pages including the annexes, the report reflects the hard work and dedication for which the Fund staff has long enjoyed high regard. However, like other Directors, I believe the report could be more concise and user-friendly with less history and greater focus on analysis of the current issues. Let me also reiterate a view that this chair has repeatedly expressed on the Board's own need for self-discipline to assure more time for a task so central to the Fund's mandate as this review of the international capital market developments and prospects.

To begin with, let me single out the basic lessons that I have drawn from our experience so far in dealing with the financial crises in emerging markets. I believe a clear understanding of these lessons is crucial if we are to avoid undue repetitions of the past. I have six observations in that regard.

First, I believe the well-founded consensus on the benefits of trade liberalization cannot be transferred uncritically as adequate argument for a comparable acceptance of the virtues of liberalized capital markets. While some openness to external capital is indeed critical for trade and growth, it is important to calibrate greater exposure to international capital markets in the light of an economy's potential vulnerability to volatile flows. A more deliberate approach to first establish the a priori case for capital market liberalization is, therefore, critical.

Second, we are rarely dealing with a world of first-best choices so that the typical policy issue is not whether but how best to intervene in order to assure a second-best outcome. Indeed, I believe there is merit in the view that the Asian financial crisis began not because there were structural deficiencies, which are only to be expected in developing economies, but because capital market liberalization proceeded notwithstanding these deficiencies. Here, let me underscore the need to respect the incidence of what the staff rightly calls "a particularly perverse set of market dynamics." This also spotlights the wisdom and sense of history that the Fund's founding fathers had in dealing with capital controls.

Third, I believe exposure to periodic crises is inevitable for a liberalizing economy since a mismatch of an evolving financial system's stage of development and the pace of capital market liberalization is, in practice, inescapable. Therefore, when a crisis occurs, it is important to avoid an "all or nothing" policy stance for correction of the economy's existing ills in false hopes of a final removal of possible future occasions for similar crises. Indeed, unrealistic expectations of radical policy reform could worsen the confidence crisis and prolong an economy's difficulties.

Fourth, like Mr. Guzmán-Calafell and others, I am impressed by the relative resilience of foreign direct investment in the face of the crisis. This appears to argue for a policy slant to encourage such investments over other more volatile inflows.

Fifth, in explaining how the Asian crisis deepened, the staff singles out the authorities' failure to raise interest rates adequately. However, this presumed sensitivity of market confidence to interest rate increases is based on a broader presumption of confidence in the debtor's ability to pay that may simply be missing in a crisis situation. Therefore, there is a danger that the economy's costs from higher interests in output loss, increased fiscal burden and greater incidence of nonperforming bank loans would be in vain.

Sixth, I believe the Asian crisis postmortem has once again demonstrated the need for a proper sharing of responsibility. Lack of transparency could indeed impede an appropriate risk appraisal. However, there is extensive evidence, some cited in Mr. Wijnholds's preliminary statement, that risk-taking was proceeding in the face of better advice. Tightening the risk-appraisal process, preferably in an international context and including possible grading of the risk-monitoring agencies' reliability, is therefore in order. Here I take comfort from the work proceeding under the aegis of the Basle Committee. I am also looking forward to further results from research into the dynamics of the investors' "herd" instinct that the staff reports on p. 11.

The report appears to come short on some of these lessons. As other Directors have pointed out, the staff seems to take the virtues of capital market liberalization for granted as if the matter has been demonstrated as thoroughly as in the case of liberalizing the merchandise trade. I welcome, therefore, the tacit recognition of the problem in the staff's appreciation of the limited case for capital controls. There is no such appreciation, however, of the need for viewing crisis-related reforms in a historical perspective so as to avoid an appearance of addressing all of an economy's accumulated institutional limitations at once. I would also underscore the importance of avoiding an impression of blaming the crises mainly on the economies that are the primary victims. Indeed, the report provides evidence that immunity from crises cannot be assured to even economies with an exemplary macroeconomic and structural policy record.

Turning to the issues for discussion, I fully share the staff's analysis of the risks posed by the continuing weaknesses of the Japanese economy and the serious implications of the problems facing the Japanese financial system. Here, I strongly hope the recent changes in Japan's economic management will be followed by early and decisive action commensurate with its importance not only to Japan but also to the world as a whole. While the dangers of an asset price correction and questions regarding the current account deficit in the U.S. are a concern, the risks on that account are somewhat mitigated by the economy's strong fundamentals and the likely longer investment horizons of many U.S. equity holders. Risks also arise from concerns over prospects of an early recovery of the crisis economies in Asia. Vigorous pursuit of progress in the adjustment and reform effort is, therefore, crucial. Clearly, this is only feasible as part of a continued international initiative.

Regarding further action in the emerging markets, it is important to first rationalize the policy framework so as to limit expectations of policy changes and institutional reforms beyond those considered essential to turn the crisis around. This would include continued macroeconomic improvements as well as an orderly and selective approach to structural reforms including especially reform of the financial system. At the same time, as noted in Mr. Yoshimura's preliminary statement, it is important to heed the regional and global implications of a simultaneous pursuit of a restrictive macroeconomic policy in deeply interlinked economies. It is therefore important to approach the corrective policies within a broader regional perspective.

On external capital market liberalization, the focus should be on more studies of the prospective gains, and the modalities for an appropriate pacing of reforms. While occasional crises driven by excesses of the entrepreneurial spirit cannot be avoided entirely, I would underscore the importance of financial sector reforms in the emerging markets with focus on elimination of anomalies such as incentives for short term borrowings for financing of longer term investments. Given that more time must elapse before all economies have the requisite financial system reforms in place, I would also urge further study of the suggested transitional role for fiscal incentives as means of coping with surges in capital inflows.

In conclusion, I fully share the concerns in the preliminary statement from Mr. Shaalan and Ms. Farid on the advisability of floating the exchange rate in a time of financial turmoil. I will also be interested staff views on likely results of a more measured approach through devaluation with the peg in place. Further, I would, like other Directors, appreciate an assessment of how lessons from the experience in Asia has come to inform Fund policies in Russia and other emerging markets.

Mr. Zoccali and Mr. Costa submitted the following statement:

It is difficult to do justice to the comprehensive and stimulating analysis presented by staff. International capital markets are under constant change: their increasing globalization "pari passu" with the expansion of international financial conglomerates provide investors and borrowers with innovative financial instruments for unbundling and redistributing financial risks. The rapid pace of these changes, in turn, generates additional uncertainty regarding the resilience of the system. Finally, the swift transmission of disturbances and the propensity for herding behavior by market participants heighten the risk of a full-blown financial crisis actually occurring.

Against this backdrop, some preliminary conclusions may be drawn. First, the need to adapt to the rapid pace of change applies both to emerging as well as to a considerable number of mature financial markets. Second, given the enhanced potential for the rapid propagation of crises, national authorities should be cognizant of their global responsibilities and take decisive actions of a prudential or corrective nature at an earlier stage when domestic or international conditions so warrant. Third, there is a need to increase our understanding of market behavior to reduce "herding" as well as decisions inspired by moral hazard considerations.

Regarding the issues for discussion, we should start by looking at the prospects for growth in the world economy to assess the major risks and uncertainties in international capital markets. In our view, a deflationary scenario should not be considered implausible if the Asian financial crisis should become more protracted, involving not only Japan but also China. Moreover, although a deflationary environment would reduce the risk of large equity-price corrections stemming from a sustained rise in interest rates, it increases the prospect of a decline in profitability, that to some extent is already being felt. A sharp general correction in equity prices, therefore, could intensify the deflationary trends that are thus far circumscribed to oil and non-oil primary commodities. Emerging market countries with strong fundamentals and sound financial systems, including many Latin American countries, could nevertheless benefit from an environment of abundant international liquidity and low interest rates despite adverse terms of trade movements. Overall, the greater opportunities for investment and growth in emerging market countries suggest that those with strong macro and structural fundamentals will be well positioned to successfully weather the present turmoil and come out strengthened as was already the case after the 1994/95 financial shock.

The main uncertainties and vulnerabilities in emerging markets depend clearly on the group of countries analyzed and on the particular characteristics of the individual countries themselves. Even amongst countries in the Pacific rim, conditions differ in terms of their ability to take advantage of export opportunities, or to respond to adverse terms of trade developments or to the competitive threat associated with a further weakening of the Yen. Emerging Asian countries including Japan, face the major challenge of trying to reflate domestic demand while advancing in orderly fashion a massive restructuring of their banking and corporate sectors. Since restructurings entail considerable injections of liquidity, their effectiveness, however, will depend crucially on the appropriateness of the measures of solvency and, in particular, on the reliability of balance sheets, agile bankruptcy procedures and facilities allowing for debt/equity swaps and the participation of foreign capital.

In this regard, it is important that the recapitalization of banks and enterprises not rest entirely on government assistance and that the current stake-holders be required to increase their own equity capital participation before government assistance is provided. Where these elements are lacking, it might be preferable to proceed initially with outright nationalization of banks with the view to their future privatization. Otherwise, the liquidity injections are likely to be diverted to the foreign exchange market. Compounding pressures will in turn aggravate the fiscal costs and moral hazard, instead of contributing to the early reactivation of the economy and to financial soundness.

The introduction of the euro should bring about important changes in both domestic and international capital markets. A deeper and more liquid financial market in Europe should not only contribute to lowering transactions costs but also to attracting international borrowers and investors in search of risk diversification, making the euro a major international reserve currency. More competition brings with it an acceleration in the pace of restructuring and consolidation of the banking system. There is no reason to expect that this process will not be orderly taking into account the relatively good performance and prudential safeguards built into the banking systems of the large countries of continental Europe. The fact that crisis management arrangements are envisaged for the euro area, as noted by Messrs. Kiekens and Jonas, is consistent with the policy of "constructive ambiguity". What is important, however, is their existence to provide "ex-ante" confidence and thus attenuate the need for activation. Nonetheless, it is critical that the Core Principles of the Basle Committee be properly implemented, keeping in mind country-specific vulnerabilities and the importance of establishing clear guidelines for public support of troubled banks and closure of insolvent institutions. Given the central role of the TARGET payment system to reduce settlement risk, involving both credit and operational risks in the pan-European financial market, use of the TARGET as suggested by staff in the main paper should be encouraged.

Regarding the new lessons for financial reform and external capital account liberalization from the Asian financial crisis, a linkage to the hasty liberalization of the capital account and to the fixed exchange rate regime in those economies has surfaced. These, in our view, are stylized interpretations of events. The root of the problem should instead be found in the incentive structure contributing to an inefficient allocation of abundant financial resources and to a failure to react promptly to manifestations of decreasing credit quality. In this regard, timely and transparent reporting of balance sheets of both banks and corporations is deemed essential for assessing vulnerability and triggering early corrective action. The introduction of standards and good practices in the area of corporate governance should thus be prioritized.

As to the role played by fixed exchange rate systems regimes, a lesson to be drawn is that recommendations to move in the direction of greater flexibility should be accompanied by a clear warning that an appropriate interest rate response, a consistent and credible macro policy framework and a sound financial system are necessary to quickly stabilize the currency. In the event of exchange market pressures, an appropriate interest rate response will be needed irrespective of the exchange rate system adopted. Lack of realism regarding the scope for active monetary policy in such circumstances played a major role in the unfolding of the Asian crisis. Another important lesson has to do with the prevailing deficiencies for assessing the risk of: cross-border interbank funding, which carries only a 20 percent risk weight despite having been characterized as the "Achilles heel" of the international financial system, or of claims on OECD central governments and central banks, suggesting the desirability of a review in light of recent experiences. In any event, the increasing integration of domestic financial markets raises the issue of international coordination of supervisory activities and of the adequacy of the current sharing of responsibilities for the overseeing global financial conglomerates.

Regarding contagion effects, it is well known that financial markets can be "irrationally" exuberant during boom times and excessively lethargic in the opposite phase of the cycle. Herd behavior may be behind the contagion phenomenon. While some recent literature supports the view that it does not necessarily lack rationality, particularly in the presence of payoff externalities, the fact remains that the aggregate outcome may not be desirable, as stated in the paper. We are again left with the conventional answer that the best means of coping with contagion effects and vulnerabilities in general is by increasing transparency, strengthening the supervisory and prudential regulatory framework, improving standards i.e. for loan classification, asset valuation, margin trading and by taking prompt and decisive actions to allay actual or potential market pressures.

The surges in capital inflows to emerging markets are, in our view, explained by two main forces present in today's international capital markets: the drive towards privatization and deregulation in emerging markets, and the liquidity conditions associated with the monetary policy stance in the main reserve currency countries. Low returns in mature economies, coupled with abundant investment opportunities in emerging markets, drive capital movements and make emerging economies a reasonable investment alternative even from the point of view of risk diversification. The problem becomes more significant in the presence of excessive liquidity shifts which make more difficult the pricing of risk.

In addition to herd behavior, moral hazard considerations have been singled out by some quarters as contributing to the dynamism of capital inflows. However, as staff note, surges in capital inflows existed long before internationally engineered rescue packages were implemented and should serve as a warning that excessive concern with moral hazard may unduly serve to hamper progress on orderly crisis resolution strategies for imbalances originating in the capital account.

Regarding measures to avoid the adverse consequences of highly volatile capital flows, sound domestic policies, in the context of a credible and operationally understandable framework, are essential to maintain orderly financial market conditions. At the same time, we consider incontrovertible the case for a more explicit acknowledgment of the responsibility of more mature economies to foster orderly globalization of financial markets. Excessive volatility in major currency exchange rates, exemplified by the recent dramatic swings in the Yen/dollar rate, must also be seen as part of the problem affecting many emerging markets. To some extent this directly hinders resorting to hedging of exchange rate risk at reasonable costs, which was mentioned by staff as an important factor contributing to the Asian crisis. Moreover, it should be kept in mind that the process of global external adjustment is a zero-sum game and that the present pattern of international adjustment rests almost exclusively on the continued capacity of the US economy and of some emerging market countries to absorb the slack in Asia and elsewhere, calling for a more active contribution from other regions, most notably continental Europe.

Overall, however, we are confident that these episodes of crises will make investors more discriminate and that if an excessively sharp downturn of economic activity is avoided, there are many reasons to be optimistic regarding the prospects for the world economy over the medium term. It is by raising awareness of both international borrowers' and investors' awareness of the risks stemming from short-term capital inflows that national prudential frameworks serve to safeguard orderly financial market conditions. The Chilean taxes on capital flows to attenuate systemic risk should be assessed on their own merits and not necessarily as a temporary recourse until needed improvements in financial sector resilience and corporate governance become fully effective. Indeed staff's proposal, with which we agree, of increasing to 100 percent the weight of cross border interbank lending for capital adequacy purposes amounts to a tax on such inflows and would not be conditioned on the progress achieved in financial sector reform or corporate governance.

More specifically on the analysis provided by the staff in the background paper about the Chilean-type "tax" on short term capital inflows, while we can agree with the thrust of the conclusions two comments are in order. First, we should be careful with data sources. Although the BIS figures suggest that there may exist other channels to acquire short term debt not yet adequately registered by the national authorities, we should recall that data provided by foreign creditor banks do not necessarily conform to BOP definitions of short term debt and may not be adequate for the purposes of economic analysis. By way of example, those figures apparently include ADR holding by foreign banks, dollar denominated domestic lending by foreign bank branches and short-term loans to subsidiaries of domestic companies in third countries. A full reconciliation of different data sources would be highly desirable for reaching well considered conclusions. Second, it is true that the case for these "taxes" may be less compelling the more developed the regulatory and supervisory framework of the banking system. However, while a sound banking system and adequate information would to a great extent diminish the volatility of capital flows, the problem of surges in capital flows is not yet fully understood as stated in the ICM main paper, even when making allowance for the quality of macro management.

Finally, we fully support the publication of the comprehensive ICM analysis, with editorial changes to reflect the tenor of today's discussions and factual corrections regarding country references. In this regard, the extensive and generally positive references to the evolving Argentine financial system are not easily reconcilable with its inclusion as one of the countries most notable affected by the shift in market sentiment in mentioned in page 5 of the overview chapter of the main paper. This in fact contrasts with the references in Chapter I of the background paper that deposits continued to grow steadily and that domestic interest rates, underpinned by a strong fiscal adjustment effort, returned to pre-Asian crisis levels as early as end-November 1997. Moreover, Argentina has been able to tap international capital markets every two weeks on average throughout this period to prefinance its public borrowing requirement while improving the maturity structure of its debt. Consequently, the characterization of Argentina in the overview chapter would warrant a specific revision.

Mr. Sivaraman wondered whether a causal relationship existed between capital flows and the current account deficit, and between capital flows and domestic savings. As interest rate spreads were decreasing, what had caused the increase in short-term borrowing in certain Asian crisis countries?

Mr. Singh said that he supported Mr. O'Donnell's concern that the Year 2000 (Y2K) computer problem had been overlooked in the report, in particular the implications stemming from a possible shift to a higher demand for money in late 1999 created by investors withdrawing their savings from the financial system.

Mr. Wijnholds stated that he welcomed the quarterly distribution of the note on emerging markets. He also supported the idea of having the international capital markets exercise twice a year, given the current financial turmoil. That had been done before, and the experience had been positive. However, instead of having two large reports per year, it would be preferable if the interim report were shorter.

Given the different practices concerning the attendance at the capital markets mission meetings by representatives from Director's offices, a more uniform approach was necessary, Mr. Wijnholds pointed out.

Regarding EMU, Mr. Wijnholds remarked that he agreed with all of the comments in Mr. Kiekens and Mr. Jońaš' statement. On the lender of last resort function of the ECB, one had to be cautious how the published version was written. Given the moral hazard implications, it was preferable not to be forthright about the details concerning what the ECB might do in certain circumstances. Information on the exact functions of the ECB was considered market-sensitive, but one had to give the impression that those issues were being dealt with.

Mr. Yoshimura stated that if Chilean-type capital controls were used for prudential purposes, they should not be temporary. If necessary, countries could adjust the degree of controls—as Chile had recently done—depending on the volatility of capital inflows. Capital controls should be used flexibly, as long as they did not harm the sound development of the economy. The report, however, had not highlighted any dangers caused by such controls.

While noting that several Directors had said that drastic deregulation could expedite the outflow of capital from Japan, Mr. Yoshimura explained that those deregulation measures were an essential component of the financial sector reform. Moreover, by postponing such measures, banks and other financial institutions would escape competing with global institutions, causing the restructuring of the financial sector to be delayed. Deregulation measures would also affect the disposition of nonperforming loans held by Japanese banks. Therefore, the Japanese authorities were not reconsidering the implementation of those reforms.

The international community's concern about the understaffing of the newly established Financial Supervisory Agency (FSA) in Japan was welcome, Mr. Yoshimura said. The FSA was planning to increase the number of inspectors over the next few years to strengthen its capabilities. Establishing a system to effectively inspect the quality of banks' assets was a priority. A mechanism of quick corrective action had been introduced for that purpose. It was based on internal assessments by banks, followed by checks by external auditors, and then a final inspection was made by the FSA. That system was capable of monitoring a broad range of banks' assets.

Because Japanese banks had been downgraded by ratings agencies in recent years, many banks could not participate in the market for credit derivatives owing to the considerable risks, Mr. Yoshimura pointed out. He wondered whether the staff had any additional information.

Concerning the ECB's lender of last resort function, clear principles should have been established to avoid moral hazard, Mr. Yoshimura said. First, the lender of last resort should not lend to insolvent institutions. Second, a penalty rate should be applied. Third, collateral should be taken for any lending. However, it would be desirable to have more transparency on the management of the lender of last resort function of the ECB; thus, there was no need for constructive ambiguity. He agreed with Mr. Wijnholds's comments concerning making such information publicly available.

Mr. Joňaš commented that his statement had not implied that Japan's Big Bang reforms should be delayed. On the contrary, he agreed that they should be accelerated to avoid the potential negative consequences of the liberalization process.

In view of the current international situation, Mr. Joňaš said that he supported the idea of having the capital markets report twice a year. In 1997 there had been an interim WEO discussion, and perhaps there could be an interim capital markets report as well.

While noting that Mr. Sivaraman had said that free capital flows did not always result in a positive sum game owing to such factors as herd behavior, Mr.Joňaš pointed out that there was an asymmetry in the report with respect to recognizing the costs and benefits of free capital flows. The costs of free capital flows had been visible during the Asian crisis, while the benefits had not attracted any headlines because they had been spread over time. Also, those benefits had been ascribed to factors other than capital flows, or they had been taken for granted. Mr. Sivaraman had stated that many people in Asia had nothing to fall back on when they lost their jobs because they had not participated in the financial markets. However, many of those jobs had been created thanks to capital inflows, and that foreign capital would hopefully play an important role in putting those people back at work.

Mr. Zoccali explained that the Chilean authorities had not considered capital controls as temporary. Capital controls should be assessed on their own merits in view of country-specific vulnerabilities in the financial sector.

Mr. Donecker said that he agreed with Mr. Wijnholds's views regarding the understaffing of the FSA. In Germany, there were more than 100 staff assigned to work on banking supervision issues, and the expertise in that area was being stepped up. Banking supervision was an important issue in Japan, and it needed to be tackled decisively.

Mr. Sivaraman pointed out that the extent of the contributions of foreign capital and domestic savings to economic growth had to be determined, prior to weighing the risks.

Ms. Lissakers said that it was not clear how an internalized economy could disaggregate its source of capital to determine whether it had come from a foreign savings or domestic savings source.

Mr. Sivaraman responded that a country could find out to what extent domestic savings had been augmented by an increase in foreign flows, and then judge—at least hypothetically—the relative contributions to economic growth.

Ms. Lissakers, while agreeing with Mr. Sivaraman, stated that if foreign capital were to replace domestic savings, there might not be a net gain. However, if foreign capital were to augment domestic savings, it would be difficult to judge whether the part that came from domestic savings was beneficial, while the part that came from foreign savings was not.

Mr. Sivaraman said that he had not meant to imply that foreign capital was bad for the economy. In most of the Asian countries, domestic savings was in the order of 25–35 percent of GDP, and foreign capital was in the order of 2–4 percent of GDP, depending on the level of the current account deficit. Therefore, attracting a large amount of foreign capital and substituting it for domestic savings might be dangerous, given the risk of reversals in capital flows.

The staff representative from the Research Department explained that the staff's analysis of the dynamics of the Asian crisis had included some consideration of how the markets had perceived the Fund-supported programs, but the report had not evaluated those perceptions. In the case of Thailand, prior to the July 1997 float of the Thai baht, the staff had argued for an orderly correction of the exchange rate—not a float—in light of the continued strong reserve position. However, by July 1997, the Thai authorities had, through their interventions in the forward markets, created large outstanding liabilities. At that time, even though the circumstances had changed, the Fund's advice had continued to be against a free float. The main point was that the Fund had called for early action on the exchange rate, not whether that advice had been to float the exchange rate, or whether different advice had been given to Asia and Russia.

Mr. Shaalan pointed out that the pre-July 1997 advice for an orderly adjustment of the exchange rate had not been heeded by the Thai authorities. However, given that by July 1997 short-term liabilities had increased sharply and reserves had fallen, had the Fund at that point advised the Thai authorities to float the baht? Had that been the appropriate policy response?

The staff representative from the Research Department responded that the decision of the Thai authorities to float the baht in early July had come as a surprise to the staff. The paper—in a retrospective sense—had discussed the wisdom of moving to a free float, as the large collapses in many of the Asian crisis countries' exchange rates had contributed to enormous problems in their financial sectors owing to inadequately hedged exposures. The amount of external financing that had been available at a particular time had also been a factor in deciding whether to move to a float. However, completely withdrawing from the markets and moving to clean floats would not have been the ideal solution for those countries. After the Thai authorities had floated the baht, there had been a severe downward pressure on the exchange rate. In view of the low level of reserves in Thailand, the willingness of the Thai authorities to use interest rates aggressively to support exchange rate stability also had been questioned. The Fund's advice had focused on making the exchange rate system stable, and on the appropriate level of interest rates.

Mr. Taylor wondered whether the staff representative's previous comments referred to Thailand specifically. In the case of the Philippines, the staff had recommended to the authorities not to go to a free float or make an adjustment, but to widen the bands. Indonesia had been given similar advice. Moreover, the Philippine authorities had been strongly advised to get out of the foreign exchange market. The exact advice that had been given to the Asian countries was important and needed to be discussed further.

Mr. Yoshimura wondered what had been the Fund's advice to Indonesia at the beginning of the crisis. Indonesia had ample reserves, but they had failed to defend their currency. Could the staff comment on the appropriateness of the Fund's advice on exchange rate issues in the Asian crisis countries?

The staff representative from the Research Department said that the Fund had advised Indonesia to widen their exchange rate bands. The advice not to move to a free float had been for Thailand.

Mr. Donecker questioned the validity of the Fund's initial advice to move to a managed float in the case of Indonesia. Some staff and Directors had thought that there had been a clear overshooting of the exchange rate at the level of 5,500 rupiah per U.S. dollar level. One wondered what would have happened if the Fund had continued to advice Indonesia to stabilize the exchange rate, given their inability to implement the Fund-supported programs? Would there have been a sufficient amount of external financing available for Indonesia to follow the Fund's initial advice to stabilize the exchange rate at the 5,500 level?

Ms. Lissakers said that the Fund's monetary policy recommendations and monetary measures that had been taken by the authorities during the initial stages of the Asian crisis had been a failure, particularly in light of the policy responses and market developments in Brazil and Russia. In Thailand, Indonesia, and Korea the authorities' policy actions had actually encouraged capital flight during the first two or three months of the crisis. The Fund's advice to move to a managed float should have been supported by an unambiguous monetary policy stance. Raising interest rates alone had not been enough, as had been demonstrated in Russia. That only bought more time to fix the underlying problems. If corrective steps were not followed, then the economy would continue to suffer, and—over the long term—the market instability problem would not be solved. The report had discussed those issues clearly, and they would be discussed further in the context of the external evaluation of the Asian programs.

Mr. Sivaraman wondered whether it would have mattered if monetary policy had been extremely tight in Thailand and Indonesia. It might have temporarily forestalled the crisis; however, once lenders had realized how hollow the financial system had been, there would have been capital flight. Investors would not have risked their capital waiting for reforms in the banking system.

Mr. Wijnholds said that he agreed with Ms. Lissakers's comments that the main problem with the policy recommendation at the beginning of the Asian crisis had been in the area of monetary policy. However, in the case of Indonesia, the advice to keep the exchange rate at a certain level, or to move to a managed float, had not been wrong. The political circumstances in Indonesia had exacerbated the situation, and as a result, the exchange rate depreciation had been much larger than in the other Asian countries—by about 40–50 percent. Under those circumstances, the only response should have been to wait for the political situation to stabilize.

Ms. Lissakers remarked that the political problems in Indonesia had triggered the loss of confidence. In Brazil, if interest rates had been increased without any corrective measures in the fiscal sector, the situation would have been much worse. The crisis hit despite the already high level of interest rates. In Russia, there had been certain corrective actions; however, they had not been sufficient to convince the markets that the authorities were committed to the reform process. The Thai and Indonesian experience had shown that it would be easier for capital flight to occur if interest rates were not used as a first line of defense. In those countries, hedge funds had placed one-way bets on the exchange rate as local investors had pulled out of the market. Those one-way bets had compounded the problem, which had initially been caused by an easy monetary policy stance.

Mr. Guzmán-Calafell pointed out that in situations where the level of international reserves had been low, and access to external financing had been limited, it would have been difficult to make the exchange rate more flexible. The dilemma was not what type of exchange rate regime to introduce, but how to ensure that the economic policies that were implemented supported the exchange rate regime. Regardless of whether the exchange rate had been made more flexible or not, given the same set of economic policies, the outcome in the Asian crisis countries would have been similar.

Mr. Donecker said that he agreed that monetary policy at the beginning of the Asian crisis had been inappropriate. In the case of Korea, the Fund had a commitment from the authorities to raise interest rates, if necessary, to defend the exchange rate. However, it had been discovered later that the markets had been aware that the Korean government had not been capable of raising interest rates because of legal restrictions. Therefore, investors had been able to speculate without an exchange rate risk.

Mr. Jonáš considered that if interest rates had been raised more aggressively at the beginning of the Asian crisis, those countries would not have had such a tremendous loss of reserves. In Thailand, the speculative cost on a three-month short position had been about three-fourths of a percentage point. That had resulted in a large loss—about $15 billion—by the central bank in forward contracts in just three days. The authorities would then have been in a better position to undertake the necessary reforms.

Mr. Yoshimura stated that the type of exchange rate regime that was used was related to the management of monetary policy. In Indonesia, if the exchange rate had been devalued at the beginning of the crisis, while maintaining the fixed exchange rate regime, a great deal of confusion would have been avoided. Moreover, monetary policy could have been used more effectively to defend the fixed exchange rate, rather than the managed float.

The staff representative from the Research Department remarked that a country had to be aggressive on two fronts when facing a crisis: it had to be prepared to raise interest rates quickly to defend its currency, and policy measures had to be supported by reforms aimed at addressing underlying problems.

The staff had not fully understood the reasons for the degree of contagion within Asia, the staff representative continued. A critical factor had been lack of information, especially regarding individual countries, which had not allowed the markets to discriminate between countries. Another factor had been spillovers, which had been caused by investors liquidating their assets in one market after making losses in another market. Those factors had also interacted with the policy responses of the authorities, particularly interest rate policy.

The staff had done some empirical work on the linkages between market views and financial sector developments, the staff representative noted. However, as the group of international investors that had been involved throughout the crisis had changed, one had to be specific when referring to market views. The staff had asked market participants about their perceptions regarding Fund programs, and they had expressed concerns in the second half of 1997 about the adequacy of the financing on some of the Fund programs, particularly in the case of Korea. Some of those concerns had also reflected the fact that at the time that some Fund programs had been announced, the available data on reserves and short-term debt had confirmed the severity of the situation. Market participants had also expressed concerns about the first Fund programs in Asia, particularly the appropriateness of the tight policies.

Based on the available data, the paper had made the point that foreign direct investment into Asia had been stable during 1997; however, that information had contrasted with the pullback in interbank lending and the variability in portfolio flows, the staff representative pointed out. When there was foreign direct investment in countries, oftentimes short and long positions were taken to try to hedge that foreign investment. Together with that foreign direct investment, a firm might be raising funds domestically to hedge its exposures, even though foreign direct investment flows appeared quite stable. The paper had referred to a study that had found that foreign direct investment flows had historically not been stable. That study, however, had also found that in practice, it was difficult to differentiate between certain types of capital flows, as evidenced by the fact that certain Asian countries had overstated their amount of foreign direct investment flows owing to misclassification.

The report had mentioned that certain Basle Committee members—not the Basle Committee itself—had been discussing the possibility of raising the capital adequacy weights that were applied to short-term bank lending, the staff representative said. Those weights were currently set at 20 percent across the board. Also, certain Basle Committee members had discussed the possibility of allowing for additional differentiation in the OECD and non-OECD weights to take into account whether a member was complying with banking supervision and data transparency standards. The staff supported raising the capital adequacy weights, but pointed out that such measures could not substitute for underlying improvements in risk management by financial institutions.

Several factors had explained why interbank lending had played such a large role—particularly at short-term maturities—in the Asian crisis, the staff representative remarked. The low risk weight on short-term bank lending had been a factor. In certain countries in Asia, the amount of bank intermediation had been related to the stage of development of local capital markets, and to the prevalence of controls on nonbank lending. It had been unclear whether the differences in the capital adequacy weights for OECD and non-OECD countries had influenced the degree of capital flows. Korea had become a member of the OECD in late 1996, and changes to its weights had occurred at that time. In early 1997, certain banks had already started to cut their credit lines.

In Asia, bank financing had played a dominant role, and had contrasted with what had happened in Latin America, the staff representative noted.

Ms. Lissakers stated that the comment on Latin America must have referred to events in the 1970s and 1980s, when debt flows had been predominantly bank flows, as equity and portfolio investment had been highly restricted.

The staff representative from the Research Department responded that the comparison had referred to the more recent years.

Ms. Lissakers remarked that the risk weighting mattered in terms of the incentive structure for both lenders and borrowers. In the case of the United States, the bottom line calculation bank managers made when deciding where and how to lend was return on equity, and the capital adequacy risk weighting directly influenced the risk return calculation. For instance, if the risk weight were 20 percent, and one lent $100 million in the interbank market, the 8 percent capital requirement applied to only 20 percent of that loan or 8 percent of $20 million. Interest margins on equity on interbank lending were low but so was the capital cost of such lending under Basle rules. Similarly, for the borrowing banks, funding in the interbank market had low costs. However, from a risk management point of view, it did not make sense to provide long-term commercial or capital loans funded with one-month to three-month interbank money. The capital adequacy weights were the simplest tool regulators had to influence the risk management behavior of both lenders and borrowers.

Mr. Yoshimura said that, from the bank's point of view, one of the benefits from a country joining the OECD was to get a lower capital risk weight. As the main requirement for OECD membership was capital account liberalization, the fact that Mexico and Korea had a crisis after joining the OECD might suggest that there was a problem with the sequencing of capital account liberalization.

Mr. Donecker stated that the risk weighting was indeed important, as evidenced by the involvement of banks—including Japanese and German banks—in interbank lending to the Asian crisis countries. That aspect needed to be studied further.

Ms. Lissakers pointed out that the fact that Mexico and Korea had had a crisis after joining the OECD was most likely a coincidence.

The staff representative from the Research Department noted that many factors had driven individual banks—including regional banks—into Asia, and the report had provided some background on that. The risk weight on short-term lending had been a critical element. Prior to Korea is joining the OECD in late 1996, there had been a large buildup of claims, perhaps in anticipation to the change in weights.

A number of Directors had pointed out that there was an inconsistency regarding the use of Chilean-type taxes on capital: the report had regarded them as temporary, while the forthcoming capital account liberalization paper had regarded them as permanent, the staff representative continued. Depending on countries' particular circumstances, there could be different justifications for using such taxes. The staff had based its argument on the fact that such taxes could be circumvented, and that they would become less effective over time. Capital controls, if used for prudential purposes, should not be used on a long-term basis or as a substitute for an inadequate domestic system. However, under specific circumstances, certain countries could derive a temporary benefit from such controls.

The Chilean implicit tax could be altered according to macroeconomic and external conditions, the staff representative explained. In situations with strong capital inflows, the tax could be set higher. Varying the tax did not necessarily go against the principles of the scheme.

The evidence on the effectiveness of Chilean-type taxes was not entirely clear, the staff representative said. There was evidence that indicated that such controls were effective; however, that effectiveness would diminish over time.

Directors were in general agreement with the staff on the major risks to the outlook, the staff representative noted. There were some concerns, however, about the Y2K computer problem. The report had covered that issue, particularly the preparations that had been made. Most of the information that was available on the Y2K issue was for the mature market banking systems, rather than for the emerging market banking systems. The commercial banking sector in general was aware of the magnitude of the problem. The staff could provide Directors with additional background information, and perhaps cover that issue more fully in the 1999 report.

The report had underscored the more immediate risks to the outlook, such as the possibility of a correction in equity markets in the mature markets—particularly the U.S. market—the staff representative remarked. The report had emphasized the adequacy of financial infrastructures for coping with such a large correction. The financial infrastructure in the United States, including in some of the other major mature markets, had been strengthened considerably since 1987.

Under EMU, the use of a single currency would greatly facilitate the process of consolidation and restructuring of the banking sector, the staff representative said. However, the advent of EMU underscored the importance of having adequate mechanisms in place to deal with the supervision of banks among the countries in the euro area. On the lender of last resort function of the ECB, it was essential to have some ambiguity concerning the specifics of the interventions. However, there should be no ambiguity about the fact that there was a system of lender of last resort in place, and information on its structure should be made available.

The Fund was in the process of preparing papers on the international architecture for crisis prevention and resolution, which would look into the issue of moral hazard more closely, the staff representative noted. In the case of the Asian crisis countries, the large inflows that had gone into those countries had not, in his opinion, been based on the belief that there would be bailouts or Fund-supported programs. The concerns that had been raised by some Directors about the issue of moral hazard had been primarily forward-looking, especially in view of the recent program with Russia. Moral hazard was not per se the taking of risk. Insurance, for example, was provided to ensure that people would take certain types of risks.

The Articles of Agreement referred to the Fund making its resources available to member countries to give them the confidence to deal with maladjustments in their balance of payments without resorting to restrictions. The issue was not risk per se; it was whether there was excessive or imprudent risk. The references by market participants to Fund bailouts were misleading, as the Fund was making loans to members at market interest rates, and with conditionality. That was not analogous to a national government's using taxpayers' money, for example, to bail out the banking sector. However, the safety nets that had been provided in the past by Asian national governments to support troubled financial institutions might have created moral hazard. As a result of those past actions, certain institutions might have been discouraged from exercising discipline in their lending practices.

Mr. Wijnholds stated that although the Fund should not be too defensive about its role in helping crisis countries, it should be prepared to offer some explanations, in view of the large amounts of money that had been provided. The references in the press to Fund bailouts were indeed misleading; however, one had to keep in mind that the Fund itself had been the catalyst for generating such large financial packages.

Mr. Donecker pointed out that if Fund-supported programs did not include private creditors, and if that lack of funding were replaced with large funds of its own, actions would be similar to a bailout. Market participants, including many country authorities, perceived the Fund as having overstepped certain prudential regulations in some of their programs.

Mr. Yoshimura commented that the private sector had been involved in the Asian crisis countries. However, in the case of Russia, the involvement of the private sector had not been considered appropriate, and that continued to be a cause for concern.

Mr. Sivaraman stated that after the Fund had provided large financial packages to the crisis countries, confidence had returned to the market. However, the real turnaround had come when the private sector had stepped in and rolled over the loans. If the private sector had been more involved before the crisis had worsened, perhaps it would not have deepened to that extent.

The staff representative from the Research Department said that there were clear distinctions between the markets for financial assets and the markets for goods. In the financial markets, one dealt with different issues, such as asymmetric information and contracts. Those distinctions would be covered more extensively in the forthcoming meeting on capital account liberalization.

The paper had attempted to be balanced with regard to the treatment of the behavior of creditors and debtors, the staff representative continued. Some Directors thought that the paper had been too kind to creditors. However, the paper had also addressed issues on the creditor side, such as herd behavior, risk management, and the capital weights applied to short-term interbank lending.

As requested, the staff would survey the literature for empirical studies on the relationship between current accounts and capital flows, and between capital flows and national domestic saving rates, the staff representative remarked. Capital flows and current accounts were influenced by common factors, such as the availability of external financing. In Asian countries, the bulk of their capital inflows had financed investment, and had not reduced the domestic saving rates. However, the staff was not aware of any evidence from the Asian countries that suggested that domestic saving rates had come down owing to larger capital inflows.

On the frequency of the international capital markets reports and on whether Directors or their assistants should be included in the capital markets mission meetings, those issues should be addressed by management, the staff representative stated. The frequency at which capital flows were monitored was critical. To that end, the WEMD sessions had begun to put more weight on capital flow issues.

Mr. Yoshimura noted that the reason that the increase in capital inflows had not decreased domestic saving had been the underdevelopment of Asian capital markets. The problem was that domestic saving could not be converted directly into investment without using foreign channels.

Ms. Lissakers made the following statement:

> I welcome the free flowing discussion we had this morning. It was useful to have the staff run through the main issues that have been raised in the many statements. It was beneficial to those of us who did not have time to read all the statements to get a sense of the thrust of the comments.
>
> This well-written report illustrates that we have learned a lot, even under difficult circumstances. If one contrast the 1997 capital markets report with this one, one finds a different emphasis and examination of structural and institutional issues, which were barely mentioned in the 1997 report. The staff's enumeration of the contributing factors to the Asian crisis is very interesting, and I appreciate the way they tried to establish the linkages that led to the contagion, including the weaknesses, which were startling. The way in which the crisis was divided into five broad stages—with distinct characteristics—was helpful in analyzing the situation, given the problem of over-aggregation of data. This will also be helpful to future economic historians to better understand the dynamics of this particular crisis, and also serve as a guide to policy makers in terms of what to do, or not to do, in the event of a crisis.
>
> It is clear that the crisis has broadened the way we define good macroeconomic management; it now encompasses many concepts that have in the past been considered part of microeconomics, such as liquidity analysis and the incentives faced by individual economic actors.
>
> I have a few areas of disagreement with the staff's analysis, and with regard to the relative emphasis they place on contributory factors and the causal linkages. The progressive slide of the Japanese economy probably got a less emphasis as a causal force than is warranted. The more one analyzes the situation, it becomes apparent that the failure of the Japanese authorities to take timely measures to address declining domestic demand, and the steep deterioration in the health of their banking system, imposed substantial contractionary impulses on the rest of the region, not only in terms of the demand for real goods and services, but also in terms of the participation and continued willingness to lend by Japanese banks. These banks found

themselves pushed to shed assets rather than to add assets, despite the very low rates of return in Japan. The lack of a similar positive stimulus from Japan has to be considered one of the vital differences between the Asian and Mexican crisis of 1994/95, where trade linkages under the new NAFTA agreement, and the linkages to a dynamic U.S. economy, helped pull the Mexican economy out of the crisis relatively quickly. In this connection, I found Mr. Yoshimura's suggestion that the Asian crisis was partly caused by the strength of the U.S. economy and, hence, the U.S. dollar, somewhat remarkable.

The second area where I do not fully agree with the staff is on the role of exchange rates, but I might have misunderstood their position. On page 8 in the report, there seems to be a suggestion that the currencies of the Asian crisis countries were overvalued prior to the crisis. I wonder if that is what they mean to convey. Certainly, my understanding is that, for the most part, researchers have failed to show any significant degree of overvaluation, with possibly one or two exceptions. It is important that one put to rest the notion that this crisis was all about currency overvaluation, although the type of exchange rate regime brings out a number of interesting issues. For instance, if currencies are going to be pegged, does one peg to the major trading partner, or does one peg to the currency in which one's debts are denominated, or some combination thereof? There is room for further elaboration by the staff on the impact of the huge swings in the dollar-yen rates on the exchange rate regimes, and in the satellite currencies.

On the question of market failure, other Directors have pointed out in their statements that the staff paper is excessively sympathetic to the view that characterizes the Asian crisis as a result of market failure. The staff mentions irrational exuberance, irrational pessimism, and herding behavior. Certainly, herding behavior among investors exists and always has, and investors have certainly taken financial decisions based on insufficient due diligence. However, there is a temptation to view all investment flows, which are seen to be ex post suboptimal, as having also been ex ante suboptimal. This may be the case, to some extent, in Asia. But this does tell the whole story. Rather, I suspect that emerging market investors, as well as domestic investors, in the Asian economies expected that their investments would be supported by certain developments which did not occur, for example, further financial sector reforms and prudent management of foreign exchange reserves. Also, investors were surprised by other developments, such as new information on the weaknesses of the banking systems, as well as macroeconomic factors, such as the dramatic swing in the dollar-yen cross rate, which may explain the substantial part of the losses that have ensued. If one accepts this perspective, then a partial solution is greater transparency and information, including information to policy makers. What is also needed is fundamental financial and institutional reform, rather than new administrative controls to curb the excesses of investors, which would mask the real problems.

I have a question about the staff's apparent advocacy of short-term capital controls as a solution, such as the Chilean-type controls. I agree with other Directors who suggest that such controls deserve further research in the context of reforms of financial sectors in countries with open capital accounts, However, I am concerned that our message is going to be misinterpreted as saying that administrative controls are, in and of themselves, a solution and a protection against financial market turbulence. Moreover, as noted by Mr. Kiekens and Mr. Jonáš' statement, it would be somewhat paradoxical to recommend Chilean-type controls just when market pressures are forcing Chile itself to greatly reduce reliance on such measures in order to attract more short-term capital. As the paper also notes, capital controls did not prevent the banking crisis in Chile before institutional reforms were enacted. I recall that Mr. Eyzaguirre mentioned recently in the Board that the Chilean authorities are coming around to the view that controls on short-term capital flows may begin to exert a negative effect on longer-term inflows, and I wonder if Mr. Zoccali could enlighten us on this.

After the 1990s Mexican crisis the authorities maintained their commitment to an open economic strategy, rather than reverting to controls and protections. That has produced positive results for Mexico, and that has been the pattern by and large in Asia as well.

On crisis prevention, the paper does a good job of laying out some policy guidelines. However, the issue of the exchange rate regime needs further discussion. The experience of the Asian crisis countries raises the question of allowing countries that are receiving large capital inflows to make and exchange rate adjustment, rather than trying to sterilize the inflow. This may be the lowest cost option over the longer term, as the evidence seems to show.

The clearest message from the Asian crisis is the importance of the banking system for reasons which have been known to regulators. Commercial banks have an imbalance in the structure of their balance sheet: the liability side of the balance sheet by and large is a fixed nominal value, while the asset side can fluctuate, and whereas equity markets and other securities can experience very large price adjustments without triggering a systematic shock, that is simply not the case with banks. That is what creates the moral hazard dilemma, because no government can sit by and let its banking system collapse. That is why it is so important to get to have a uniform and transparent treatment of nonperforming loans, and to take a close look at margin loans. The report refers, on several instances, to the leveraging of investment in securities and derivatives. Given that the source of the leverage is bank credit; therefore, these margin standards that banks have and that regulators oversee are very important in terms of getting at the contagion factors. This applies to the supply side—the large lending banks of the major industrial countries—as well as the demand side.

On financial engineering, I have a disagreement with the tenor of the report. It gives too much credit to "vast improvements in risk management." I am not convinced that there has been a vast improvement in risk management. It is true that this debt crisis, unlike the 1980s debt crisis, has not produced a systemic shock on the lending side, but I am not prepared to take the next step and assume that that is because of sophisticated risk management models. I attribute it to the Basle capital adequacy requirements. That has been the largest difference, because during the lending booms of the 1970s, banks ran down their capital to minute levels, and that was one of the reasons for the occurrence of a systemic shock on the lending side. The Basle rules have not permitted that to happen. Although it is difficult to identify cause and effect, I would not be so quick to discount that, and credit risk management.

The comments that I have heard from market participants, including from institutions that consider themselves among the most sophisticated in managing derivatives, suggest that they were shocked by what happened to them in Asia, referring to "exploding derivatives exposures". There is also a disillusionment with the mathematic models that are used to project risk and exposure. I wonder whether market commentators in other markets outside New York shared that view, and would like to ask staff for their views. References to revamping these mathematical models do not come through strongly enough in the report. The unreliability of these mathematic models, particularly with regard to the management of derivatives, did not play a significant part in the contagion. We do not have, however, an accurate picture, because there is such poor data on derivatives, since most of the derivatives are traded off in the market.

The supplement has a subtitle of "unbundling risks." I would strongly recommend retitling that to "rebundling risks," because investors should have a choice on the kind of risk they want to take. Some may prefer to take the interest rate risk, rather than the exchange rate risk, while some may prefer to take some type of asset risk. In the end, the two risks you cannot escape are credit risk and market risk. Investors seem to keep having to relearn that lesson. You can reengineer the mathematical models as much as possible, but that is the reality that has hit the derivative designers during the Asian crisis. The problem with the increasing abstraction of financial instruments is that the link between price and underlying value becomes more tenuous.

On the potential risks and pitfalls in the future, Mr. O'Donnell mentioned a further drop in commodity prices. The drop has been quite dramatic this year; however, there is not much that can be done to stem this drop.

I agree that the Y2K computer problem is serious, particularly because of the financial market linkages and the vulnerability of payment and settlement systems to a major disruption if individual institutions and individual investors do not manage the Y2K problem properly. One's initial reaction is that this problem cannot be too difficult to fix, but apparently it is. I have become convinced, from reading many articles on this subject, that it is an extremely complex problem. The world's financial system is vulnerable to shocks, and it is incumbent on all financial managers, including governments and central banks, and this institution, to be alert and to work through this problem before December 31, 1999. Some period of testing is highly advisable. One would not want to find out on the morning of New Year's Day that the problem was not corrected.

The most immediate threat in Asia would be the failure to carry through expeditiously corporate and banking system restructuring. Japan is an example of costly delays can be. Compound interest rates work against countries. That is what is currently happening in Indonesia, and in several of the other crisis countries.

Mr. Eyzaguirre responded that the Chilean tax—or reserve requirement—was designed to affect primarily short-term inflows. For instance, it would add 300 basis points to a one-year loan, 150 basis points to a two-year loan, and so on. However, in view of the recent increase in interest rate spreads, the Chilean authorities had considered that those controls had been exerting an additional borrowing cost on long-term inflows, and thus had reduced their reliance on such measures. With the reserve requirement at 10 percent, short-term inflows were still not being encouraged, even though the risk of having large inflows was minimal. However, if capital inflows began to accelerate, the authorities were prepared to increase reserve requirements again.

Mr. Donecker made the following statement:

We welcome today's discussion on recent developments in international capital markets; in particular, the report's focus on the Asian crisis, and the linkages and risks associated with the situation of the Japanese economy. The staff has put tremendous amount of work into this extensive and informative report, as evidenced by its high quality. However, I agree with Mr. Bernes, Mr. Wijnholds, and others that a somewhat more concise and focused report, with some of the more technical issues moved to a background paper, would have been more user friendly. Like Mr. O'Donnell has stated, the sheer volume of material threatens to weaken the impact of the analysis and recommendations.

Against the backdrop of our overloaded agenda shortly before the Board's recess, I am afraid that we are rushing our discussion on this important, voluminous report. I am, for instance, still trying to catch up with some of our colleagues' very late preliminary statements, as pointed out by Ms. Lissakers. I wonder whether that is the responsible and efficient way to deal with these important issues. I will focus my comments on a few major points, but I must say that I feel very uncomfortable with this rushed procedure.

My first point relates to the question of whether the Asian crisis constitutes a new type of crisis that might require new answers. The staff has elaborated quite extensively on the similarities and differences with earlier emerging market crises, and I do not need to repeat them. There is clear evidence that domestic factors, as well as external conditions, have contributed to the emergence of this crisis. The most important conclusion from this is that we are not dealing with a new type of crisis. The Asian crisis has shown that domestic factors, notably policy deficiencies, particularly the failure to adjust promptly and forcefully to changing economic circumstances, were first and foremost responsible for the emergence of this crisis. As Mr. Gorbachev once said, history always punishes those who act too late. One could also say that markets punish those who fail to adjust and to take proper precautions to safeguard themselves adequately against obviously existing large risks.

I would like to highlight the following failures during the Asian crisis. First, on exchange rate policy, the failure to maintain for too long a close exchange rate link to another major currency, even though it was clearly unsustainable in view of the economic fundamentals. Second, on monetary policy, the failure to raise interest rates and to curtail credit growth because of the perceived need to protect already weak financial institutions and highly leveraged domestic corporations. This implied that the cost of speculating against currencies remained low and contributed to large private domestic capital outflows during the crisis. Third, on structural policies, the failure to address promptly and forcefully deep-seated structural weaknesses, notably the "weakly supervised and regulated financial sectors, poor risk management in financial institutions, problems of connected lending, weak corporate governance, problems of moral hazard in the financial and corporate sectors associated with implicit or explicit national safety nets." Fourth, the extent of political cronyism and corruption in some of the affected economies that impeded the urgently-needed fast corrective actions, as well as the fast return of confidence.

The currency weakness of Asian crisis countries, as the staff has rightly pointed out, was "further compounded by market concerns about the adequacy and implementation of the first round of Fund programs and the degree of domestic political commitment to reform." Herein lies the central answer to Mr. Yoshimura's question as to why Indonesia was so deeply affected in spite of Fund programs. In the case of all the crisis countries, the fact that market participants initially expressed doubts about their commitments to the economic reforms included in the Fund programs, indicates very clearly that the program itself and the credible commitment to decisive reform—not the financing—are of paramount importance to regain confidence and, thus, key in successfully dealing with crisis situations. One important and fairly new factor in the Asian crisis is the extent to which the structure, denomination, and volume of private indebtedness is also responsible for the depth of this crisis. This requires new approaches to crisis solutions; in particular, the early involvement of the major private creditors in any crisis resolution package. This aspect should be dealt with more clearly and with somewhat more urgency in the report. I would caution against the illusion that necessary adjustment and structural reforms can be circumvented by incurring new major risks, for instance, by tapping into highly liquid markets and accepting unreasonably high spreads.

Against this background, the main risks associated with emerging markets are political and social instability, combined with the danger that the implementation of needed structural reforms will remain piecemeal and will be delayed due to vested interests. Strong adjustment efforts are also required if the risks associated with the potential negative developments in Japan, the decline of commodity prices, and the potential rapid fall of equity prices in the more mature economies are to be contained.

On the factors underlying the large surges in capital flows to emerging markets and the reasons for the typically abrupt and sharp reversals, I concur with most of the staff's findings, in particular with regard to the importance of liquidity conditions in the advanced markets with regard to large institutional investors, and with regard to portfolio diversification and the dynamics of herding. However, like Mr. Wijnholds, Mr. Milleron, and others, I do not fully concur with the staff's findings on the extent to which private investors are encouraged to undertake imprudent risks on account of the expectation of official support. The staff admits that it does not seem unreasonable that the support in the form of implicit or explicit safety nets provided by national authorities "would be taken into account by international investors and their acquisition of claims on entities".I am quite surprised, but not convinced, by the staff's finding that "there is no evidence that private capital flows to Asia were based on the expectation that the international community would need to put together packages to bail out international investors". Mr. Wijnholds in this regard has challenged the staff's findings quite comprehensively, and I subscribe to the arguments he has made. Indeed, "the potential moral hazard effects of the financial rescue packages in the aftermath of the crisis are far from negligible, and it would be a mistake to ignore them". This more forward looking perspective needs to be better taken care of in the final version of the report. In our view, international investors, in their acquisition of claims on entities, did take into account the existence of the IMF.

All these considerations, however, underpin the view we have already expressed on various occasions: early involvement of the private sector in the resolution of financial crises, in particular the participation of private creditors and the main creditor banks—in a fair burden sharing—is absolutely necessary. Against this background, it is no surprise that, as evidenced in the case of Korea, "external confidence remained very weak, and large capital outflows continued until agreement was reached to roll over and eventually restructure Korea's external debt." Also, I fully agree with what Mr. Sivaraman has said on this issue.

Short-term capital inflows should not play a supporting role in helping some emerging markets cope with surges in capital inflows. The introduction of even carefully crafted taxes on short-term capital flows would not be helpful, for the following reasons. First, it remains questionable whether the introduction of such restrictions would be able to prevent speculative attacks, particularly in emergency cases. After all, taxes only increase the costs of speculation. They may dampen somewhat the rise of a speculative fever, but they do not prevent speculation. Second, the potential for and likelihood of circumvention is great in view of the highly sophisticated markets and instruments, and is even likely to increase over time. Third, the introduction of capital restrictions could turn out to be very risky because it may result in a loss of confidence and, thus, trigger large capital outflows. Fourth, protectionist measures of every kind reduce the pressure to provide for sound fundamental conditions. Moreover, they will most likely weaken market discipline. In our view, greater exchange rate flexibility, an appropriate interest rate policy, and tight control of the money supply and credit expansion are a much better approach to cope with speculative pressures, in particular if they arise due to structural deficiencies. Some authors referred to the success of Chilean-type controls. However, as Annex 4 reveals, there is little empirical evidence regarding whether the Chilean controls have been effective in reducing the accumulation of short-term external debt. In addition, some authors argue that Chile owes its financial stability not to capital controls, but to a strong banking regulation, and I would agree. Germany had a short-lived success with a similar measure—the Bardepot—which was implemented about 25 years ago because of a massive circumvention of capital flow restrictions. I am surprised, like Mr. Wijnholds, that we are basing our research only on the English-speaking literature when there is also ample literature available, for instance, on the German Bardepot. The Bundesbank has put out some frank reports and criticisms of its own actions in this area, and has accepted that this was a failure. We can learn from this failure. Maybe the staff should have somebody who reads German who can also draw the right conclusions from these reports. Otherwise, I am willing to help out by providing a few English texts.

In the area of EMU, Mr. Kiekens and Mr. Milleron have already expressed some reservations, which I support. On crisis management procedures within EMU, the report states—and Mr. Yoshimura criticizes—that the lender of last resort responsibility has not been assigned to any supernational institution in EMU, and that consequently there is no central provider or coordinator of emergency liquidity in the event of a crisis. In our view, which is shared by many around this table—central banks should not take an official and formalized lender of last resort function, which is mainly done to avoid moral hazard. Liquidity crises have to be solved through private or semiprivate institutions, such as the Liquidity Consortium Bank, deposit insurance schemes, proper prudential standards, and official supervision, as is the case within the German framework and in many other countries.

Explicit provisions for the behavior of the central bank in the event of a liquidity crisis, which cannot be solved within the private sector, in our view, are counterproductive. First, each crisis has its own individual dimensions. Thus, standardized procedures appear inappropriate. Some kind of ambiguity on when and to which extent liquidity support will be provided is necessary and desirable in order to cause banks and other economic agents to manage risk taking adequately, and, thus, stabilize financial markets through enhancing market discipline. Moreover, the mere existence of a provision on emergency liquidity assistance may contribute to moral hazard. As evidenced by the Asian crisis, the existence of implicit or explicit safety nets provided by national authorities has proven to have a negative impact on the behavior of financial market participants. I note in this context that the staff paper on theoretical and practical aspects of capital account liberalization, which is scheduled to be discussed on Monday, August 3, 1998 also refers to the problem of moral hazard. I quote from this paper (SM/98/197, 7/17/98) in paragraph 47: "Especially, moral hazard can potentially be associated with problems of systemic dimension. The most important problem in this area is almost surely the moral hazard created by extensive explicit and implicit government guarantees for financial institutions and sometimes other types of enterprises without adequate safeguards against imprudent risk taking by such institutions or sufficient incentives for market discipline to work effectively to police excessive risk taking." This message should be included more comprehensively and more clearly in the published version of our report. We, too, do not agree that the current arrangements between national supervisors and the ECB about the exchange of supervisory information seem inadequate, for the reasons enumerated by Mr. O'Donnell.

As to the TARGET payment system, the report states that it may not yield the expected reductions in systemic risk due to competition from other payment systems in Europe, and that consideration should be given to reduce fees if they were too high in comparison with other systems. We beg to differ on this. In our view, there are no reasons to concentrate the processing of large value payments on TARGET because of systemic risk reduction if there are other payment systems, such as the Euro Access Frankfurt 2 (EAF2), which also processes large value payments at a very low risk level, comparable to TARGET. Under these circumstances, it should be left to market participants to decide on whether to use TARGET or, for instance, EAF. According to the view of the former European Monetary Institute (EMI), and that of the EU Commission, the principle of full cost recovery of TARGET should be maintained in order to guarantee a level playing field with other payment systems. I will provide the staff with further comments of a more technical nature on the TARGET system separately.

As to suggestions on future issues to be considered, I support the two proposals of Mr. Milleron. It might also be quite useful to take a close look at the issue of tax harmonization, and the extent to which the lack of it encourages wrong investor behavior, such as a flight into tax havens and inappropriate tax return filing.

With regard to the publication of a final revised version of this report that appropriately reflects the major concerns expressed by the Board today, I suggest that we approve its publication on a lapse of time basis.

Mr. Lehmussaari made the following statement:

At the outset, let me say that I agree with many parts of staff's analysis and that this will make a reputable report when published. I would, however, tend to agree with Mr. Wijnholds that the report is to some extent excessive. Although I recognize a lot of quality in the writing, one could argue that there is a tradeoff between quantity of information and "effective communication." In this respect there is scope for improving quality.

Again referring to Mr. Wijnholds, I think this institution should certainly not be in the forefront of downplaying moral hazard in private capital flows—at least while the jury is still out. Right or wrong, such talk does at best have no effect but could alternatively contribute to moral hazard.

On the question of what impact the single currency will have on the pace of bank consolidation and the pan-European capital market, I would argue that this process is an integral part of the ongoing globalization of financial markets. Regardless of the EMU, market integration and consolidation is inevitable, and increased activity across borders calls for increased cooperation among supervisors. But the single currency will accelerate the consolidation process in the banking sector.

I appreciate that the staff has gone into great detail to shed some light on the functioning of the European Monetary System, particularly with respect to division of work between the European Central Bank, the National Central Banks, and the National Supervisory Authorities. I find their conclusions a little harsh, however. If the recent global financial crisis can be used as any guide in this respect, I would argue that, although, in general, transparency is good, flexibility and innovation are probably the most important tools in times of crisis. I could also agree with Messrs. Kiekens and Jonáš that "constructive ambiguity" may help to avert moral hazard.

With regard to the liquidity issue within the EMU, the staff leaves out the advantages of the new monetary arrangement. The final liquidity provider, the ECB, is outside domestic business and political circles with vested interests that national central banks currently operate in. A significant moral hazard element will be removed from monetary policy operations, because not every liquidity call will go through. This contributes to lowering systemic risk.

Turning to Target, I think that the staff is again a little hasty when they infer that the overwhelming majority of transactions might be channeled through the private and quasi-public netting system, with the result that the system may not realize the systemic risk reduction that is anticipated. While their concern may be legitimate, one should not forget that costs can be adjusted as experience is gained, and there may well be some scope for subsidies in the system, should that be the price of lowering systemic risk. But staff seems to miss the key point that Target was created in order to make a single monetary policy possible—not to compete in the area of retail payments.

I question staff's proposal to replace collateral with intraday fees, because fees may not capture the degree of risk facing central banks in extending credit to a wide range of banks. Meanwhile, pooling that is already in place in some European countries offers a considerable degree of flexibility without compromising security. There is virtually unlimited access to intraday credit, given that the amount of collateral in the euro area is several times what is needed to manage the liquidity of the European banking sector. Target will thus reduce volatility, which would not be the case if there were intraday limits and banks were forced, in the case of a major shortage of liquidity, to sell assets in volatile markets.

In addition, I think the staff has left out a very important counter-balancing point; that banks and investors also have an incentive to channel large payments through Target, because they gain reduced settlement risk, both with regard to local and cross-border payments. In addition to reducing transaction cost, most recent initiatives by the private sector, aiming for swift settlement of transactions in foreign exchange or capital markets, have been driven by the desire to reduce settlement risk, as opposed to reducing systemic risk. But, by providing a forum for reducing settlement risk, systemic risk is consequently being reduced.

In particular, foreign exchange settlement risk has huge implications for systemic risk. The Fedwire system in the United States, the BOJ-NET in Japan, and Target in Europe, form the first truly global infrastructure which can be used in eliminating the foreign exchange settlement risks. This will definitely serve to limit systemic risk. The private sector is not in a position to perform this task.

Regarding short-term capital controls, it is uncertain whether taxation can give governments control over capital inflows. The ability of market participants to circumvent taxes may even create new problems, although the empirical evidence is somewhat inconclusive in this regard. More specifically, however, referring to the Chilean experiment, the evidence would indicate that such taxes come with a high price for the domestic economy since real interest rates stay very high. Quantitative controls are probably even more costly and less effective.

Alternative ways of addressing the vulnerabilities associated with volatile capital flows begin with sound macroeconomic and financial policies. However, no matter how sophisticated the policies, if there is not adequate political support behind them, policies may not be enough.

Mr. Luo made the following statement:

I would like to thank the staff for providing a set of informative, high-quality, and interesting papers.

The staff's analysis on the cost, evolution, and consequences of the Asian crisis is helpful in deepening our understanding of the crisis, and it provides some guidance for other emerging markets in avoiding the re-emergence of similar crises.

At present, the uncertainties in the Japanese economy and the Japanese yen are the major cause for concern in international capital markets. The Japanese economic growth and the strength of the Japanese yen have an important bearing on the economic recovery of the Asian crisis countries, given the trade and financial links and their effect on market confidence. A continuing economic recession in Japan and a weakening of the Japanese yen will seriously affect the recovery and the stability of not only the hard-hit Asian crisis countries, but also other Asian economies, and even the world economy. Therefore, we urge the Japanese authorities to take timely and effective measures to restructure and recapitalize the banking sector, stimulate domestic demand, and create a favorable international environment for the recovery of the regional economy.

The Asian crisis has not yet made a turnaround. Taking into consideration the time needed for structural reforms in the crisis countries to take effect, and the uncertainties in the Japanese economy, there is a risk that the Asian crisis may widen and affect other emerging markets, including the international capital markets.

Owing to the limited depth of the emerging markets, large amounts of capital outflows will impose further pressures on emerging markets outside Asia, and cause a broadening of the crisis. The uncertainties surrounding the mature markets are mainly due to concerns about possible interest rate increases in the major industrial countries, such as the United States and the forthcoming EMU area. The timing of that adjustment is a critical factor. The growing inflation pressures in the United States, and the need to establish the credibility of the new currency—the euro—have justified the above concerns. We are also concerned about the possible impact of higher interest rates on the Asian crisis countries and, in turn, the world economy. Therefore, we hope that industrial country authorities give due consideration to the possible impact of interest rate adjustments in their economies. As Mr. Newman said recently, the best thing that can be done now is to do nothing.

Another uncertainty comes mainly from a possible abrupt correction in equity prices in the United States and some of the European countries. The high corporate earnings expectations and the flight to quality behavior by investors since the Asian crisis seems justified by the concerns of an equity price correction. If an equity price adjustment occurs, it will adversely affect the international capital markets, and cause further deterioration in the emerging markets.

The main factor contributing to the sharp exchange rate depreciations in the Asian countries and the contagion effect are sudden changes in market confidence owing to problems in the financial sectors of the affected countries, such as a lack of confidence in the adjustment program supported by the Fund, some slippages in monetary and exchange policies, responses to the crisis, and the herding behavior of market participants. Financial sector reforms in the Asian countries should be concentrated in the restructuring and recapitalization of the banking sector. By improving bank's balance sheets and their ability to intermediate funds, then the problems of the credit crunch and enterprises could be solved. In order to speed up the restructuring of the banks, a rescheduling of private debt is necessary. Adequate government involvement in solving the problem of bad loans in the banking sector is also critical.

Although foreign participation will facilitate banking sector restructuring and recapitalization, and strengthen corporate governance, the appropriate degree of foreign participation needs to be carefully considered, given the weaknesses of the banking sector in the Asian countries. The Asian crisis has shown that a sound financial sector—especially the banking sector—is one of the necessary conditions for the liberalization of the capital account. The staff pointed out in the report that the combination of a weak banking system and an open capital account is an accident waiting to happen. Therefore, any liberalization of the capital account should be accompanied by financial sector reforms, and should be undertaken in a cautious and orderly way. The sequence in which the capital account is liberalized is also important. For the more volatile short-term capital flows, various forms of taxation, such as those used in Chile, could be imposed to prevent excessive inflows.

The 1980s debt crisis, and the Mexican and Asian crises, have some common features that occurred prior to these crises: large inflows of foreign capital to the emerging markets owing to the higher rate of return of these markets compared to mature markets, sound macroeconomic foundations, relatively fixed exchange rates, and explicit or implicit guarantees provided by the governments. Increasing—in an orderly manner—exchange rate flexibility and the obligations of government guarantees, strengthening prudential regulations, and imposing market-based controls on short-term capital inflows, will help reduce the large swings of capital flows.

The decision on who the first-round participants of EMU are, and the lock of bilateral exchange rates have substantially reduced the uncertainties leading up to the launch of the euro at the beginning of 1999. The single currency will promote the restructuring and consolidation of the banking system, and the development of the Pan-European capital markets. However, it seems that the envisaged crisis management arrangement is not adequate enough to deal with problems that may arise as a result of accelerated banking sector restructuring. Therefore, we hope that the supervision mechanism in the EMU countries could be further defined to avoid any negative effects on the market. The start of the TARGET payment system will play an important role in reducing systemic risks in the pan-European area. However, due to the competition from other payment systems, its role should not be overestimated.

Mr. Taylor made the following statement:

The issues identified in the fifth issue for discussion were the most important part of the paper, namely, what is contributing to capital surges, and what, if anything, can be done to mitigate the consequences. On the whole, the paper does a good job of addressing those issues.

What struck me the most is how herding behavior has come out of the shadows in academic and official thinking, and has now taken center stage. Some rethinking of preconceived views on herding behavior would be in order. For example, it is very interesting, as pointed out by Mr. Donecker, that German second-line banks seem to have done a lot of herding, whereas United States banks have not. I wonder why that would be. Part of the answer to herding is seen as better disclosure, which, of course, has center stage in our agenda, but it may be possible that information also tends to be interpreted in a herd-like way. Mr. Greenspan has wondered whether irrational exuberance in the U.S. equity market has caused excessive prices, even though the U.S. equity market has more information available to it than any other market in the world. We have to give some thought to the evidence that successful policies—or policies which are perceived to be successful—may generate herding. The important point is that actual successful policies may generate herding, and this will be a problem—at least for small countries—where the available supply of savings from outside vastly exceeds the savings from within the country. Issues like capital controls are being discussed as a means of holding a realistic rate of inflows. Its an issue that needs to be addressed, preferably with an open mind and not with preconceived views.

It was difficult to mitigate swings in capital inflows. As exchange rate arrangements in the majority of Asian countries become more flexible, it is important to state more clearly than we have to some of the East Asian countries in the past 12 months, that this does not remove the problem of volatile inflows. It perhaps changes the characteristics of the inflows, and possibly the appropriate policy response. As Mr. Yoshimura has reminded us, an alternative anchor is almost certainly needed for the countries that have been moving off fixed exchange rates.

Much has been said about moral hazard in the statements and in today's discussion; however, I did not altogether follow the logic in Mr. Wijnholds's statement on this issue. We tend to worry a bit too much about so-called Fund bailouts. What does worry me, however, is when the conditions of a Fund program are inadequate, or if they are not implemented. That is why the Russian program is worrisome. There should have been monthly tranching, given that there was serious doubt about the adequacy of the conditions, and serious concern about the track record. If we can be sure that we have the right set of conditions under a program, then we should not be unduly concerned about the aspect of moral hazard. There was, however, substantial moral hazard in the explicit and implicit government guarantees on institutions within the countries that have had difficulties. It is important that governments ensure that market-based work-outs of bad debts occur under adequate bankruptcy provisions; that issue may not have been raised. If it is, perhaps it could be emphasized further. If there is no credible threat of market-based outcomes, then investment decisions and prices will continue to be distorted.

I would like to point out what Mr. Yoshimura said in his statement, that the paper provides little space as to how the Fund has performed. Although it is difficult to incorporate an assessment of how the Fund has performed, the Fund should try to learn as much as possible from what outside critics are saying about it, and indicate that it is an institution that is willing to learn from past mistakes. Since that is the main criticism of the Fund's work, perhaps something could be said in the paper to try to offset that impression.

On the issue of the adequacy or inadequacy of interest rates to stem the crisis, as discussed in page 97 of the report, it is certainly true that market participants widely questioned the appropriateness of tight monetary policies. In the case of the Philippines, businessmen, including central bankers, said that the exchange rate does not matter too much, but that high interest rates are hurting more. It is not enough to dispose of those attitudes or beliefs by assertion, which is what is done on page 97. At some point, we have to get more analytical. Some central bank governors in Asia felt that, given the political situation in their own country or in neighboring countries, any level of interest rates was immaterial. Acknowledging that there is some balance of costs and benefits to be made with a particular interest rate policy would go a long way in improving communications with the central banks in Asia.

Hedge funds have been highly criticized, and one of my authorities feels that the Fund is now going a bit far in blaming hedge funds for the Asian crisis. The short positions in the Thai baht were about 5 percent of Thailand's GDP.

Hedge funds' short positions in Australia in June 1998 were estimated to be about 3 percent. These are pretty big numbers.

Mr. Donecker stated that although he was surprised that German banks had been involved in some of the Asian countries, he was aware that many U.S. regional banks had also been involved, and that the U.S. banks had been the ones who had done the herding and had rushed out of the Asian countries. However, German banks had not pulled out of Korea during the crisis; they had in fact increased their exposure at the time of highest risk, given that Korea was an important market.

Ms. Lissakers said that there were fewer U.S. regional banks involved in Asia than in the 1980s Latin American crisis, given that a number of those banks had been caught in the herding that had occurred in that crisis. Another factor was that, at the time of the Asian crisis, the U.S. economy had offered more attractive lending opportunities for the regional banks on the home market than, for example, Germany had. Historical trends had shown that exposure to riskier markets increased as there were fewer lending opportunities in the home market.

After adjourning at 12:55 p.m., the meeting reconvened at 2:30 p.m.

Ms. Vigliotti made the following statement:

I would like to commend the staff for the high quality of the report, and would like to concentrate my comments in four areas, including the global outlook for the capital markets, the Asian crisis, developments of mature markets and EMU-related issues.

Notwithstanding some recent signs of recovery in emerging financial markets during the past few weeks, the international capital market outlook remains overwhelmed by the large uncertainties related to the resolution of the Asian crisis. The deepening of economic contraction in Japan, and the related sharp decline of the yen, are seriously affecting developments and prospects in the region. While the yen depreciation is consistent with the weakness of the Japanese economy, it adds negatively to the already fragile situation of the region's financial system. Where fixed exchange rates are maintained, namely in Hong Kong and China, the risk of speculative attacks against those currencies is heightened. Crucial for stabilization of financial market conditions in the Asian countries would be firm evidence of economic recovery, and progress in financial sector restructuring. The improving trade position of some Asian countries, particularly the behavior of export quantities, suggests that an export-led recovery may eventually start, especially in those countries that have experienced the largest devaluations. However, the restructuring of the corporate and financial sectors has not been adequately addressed. Given the slow reform progress, the outlook for domestic demand—and also confidence—remains subdued, and investor confidence limited. The pace of financial and corporate restructuring must be increased; otherwise, the crisis will continue and probably spread.

The debate concerning the causes of the latest financial crisis has focused, inter alia, on the role of global capital market investors. Some believe that the opportunistic behavior of investors was one of the main sources of the crisis, while others think that investors reacted mostly to inconsistent domestic policies. Both factors seem to have played a role at the beginning of the crisis, which may help explain the sudden onset of the crisis. The composition of capital flows was another important factor, as crises appear more frequently, and with greatest virulence, whenever there are large capital flows. The severity of this crisis could also be related to moral hazard, and the behavior of banks in their lending decisions. It is difficult to draw lessons from the Asian crisis, and also to come up with a set of measures to avoid future crises. The onset of global financial and economic integration requires that close attention is paid to the consistency of domestic policy mixes and the degree of openness of the economy. In particular, the commitment of governments to maintain fixed exchange rates in the presence of free and strong capital movements implies that strong pressure on monetary policy must be absorbed. The lack of a strong monetary response, as was the case in some Asian countries during the previous year, may increase the possibility of a credit crisis. Under a fixed exchange rate regime, confidence in the system or moral hazard behavior may create additional incentives to borrowing. This problem is exacerbated in the countries with ineffective prudential regulations and weak financial institutions. This underscores the importance of more effective monitoring and regulation of the asset and liability structures of financial institutions. Other measures to manage the process in a more orderly fashion may include taxes on short-term capital inflows, and greater foreign ownership of financial institutions. These issues deserve further research and reflection.

On developments in the mature markets, a recovery in Japan is crucial to the outlook in the Asian region. However, under the current policy framework and market conditions, the scope of the recovery remains limited, mainly because of the temporary nature of the envisaged tax cuts in Japan. A more comprehensive tax reform, or at least the lengthening of the period at which tax cuts operate, would provide greater incentive for individuals to adjust their spending behavior. However, a recovery in Japan seems to be impeded by the still unresolved problems in the financial sector, particularly in the Big Bang reforms. The measures taken by the government have helped to relieve short-term funding problems, and have avoided a further shrinkage of balance sheets, but critical measures remain to be fully implemented, especially the strengthening of the regulatory framework and the containment of moral hazard. Provision of public funds should not weaken market incentives further to undertake needed reforms.

In the non-Asian equity markets, the performance has remained almost unaffected during the course of the previous quarter. European markets were the strongest, especially those of core Europe, which benefitted from the most evident signs of domestic-led growth. The ongoing process of privatization and the spread of merger and acquisition activity is supporting the buoyancy of European equities. The successful realization of the EMU project, which implies the creation of the largest domestic financial market in the world, is contributing positively to this trend.

In the U.S. market, flight to quality investments and a noninflationary growth environment are boosting prices to levels which could be unsustainable. In particular, there are doubts about the consistency of those equity prices and the profits outlook. Other factors could be fueling that price trend, such as easier access to mutual funds, and the trend toward funded pension systems. Over the short term, prospects for low interest rates have supported the price dynamics of equities. Should a correction occur, the main risk appears to be larger for the Asian countries, where the fallout of an international stock market decline could create a new round of turbulence, with potential spillover effects to other emerging markets. Such a development, which implies a worsening of the global economic prospects, would pose serious challenges for the conduct of economic policy throughout the world.

Without taking into account the international repercussions, the wealth effect derived by a moderate correction in equity prices could compensate the industrialized countries which are most advanced in the economic cycle, namely the U.S. and the U.K., as such factors could push the economy above potential growth. In the industrialized countries in which the ratio of equities to total wealth is not large, the impact should not be as important.

The launching of the euro and EMU will exert a profound effect on European capital markets. EMU will integrate the government bond markets of member countries, and will spur the liquidity and depth of euro-denominated bond markets. It is also expected to speed up the process of securitization in Europe. This trend will help develop a European corporate debt market which, up to now, has lagged behind other financial centers, by allowing only the largest firms to participate in international markets. Such developments in financial markets will add to the competitive pressures already operating on the European banks. In particular, the expected acceleration in the securitization process will negatively impinge on the profitability of the European banking sector, which unlike the banking sectors of the United Kingdom, Canada, and the United States, still relies heavily on traditional banking activities. The introduction of the common currency will require that the banking sector to be restructured at a faster pace. That will increased the transparency in banks' cost structures, and eliminate currency risks. The elimination of currency risks is expected to boost the process of diversification of household portfolios, and to widen the size of the market for the services associated with the placement of corporate bonds. These are two main opportunities for the European banks, in addition to the benefits associated from the recovery of economic growth.

Some have argued that under the pressures of a more competitive environment, banks could deal less prudently in evaluating risks. The current framework for banking supervision and prudential controls in the EMU area should, however, be adequate to cope with any forthcoming pressures. however, a closer coordination among national authorities concerning the supervision of the banking system is important. Three committees are in charge of this coordination, as well as the various arrangements concerning the division of responsibilities and exchange of information among supervisory agencies.

We see stronger growth and stability in the European capital markets and continued growth in the U.S. markets. However, there are some concerns about the position of the economic cycle, and the overvaluation of some financial assets. Weakness in Japan is tempered by the belief that better policies may contribute to an improved financial outlook. Nonetheless, there is an extreme fragility in emerging markets in both Asia and Europe. The next six months are likely to be critical, and will indicate whether the global financial markets are recovering or not.

We have some comments and corrections on the paragraph on the Italian banking sector, and will provide the staff with a written summary.

Ms. Lissakers remarked that she welcomed the discussion in the report on the responsibilities and mechanisms of the ECB regarding its function as a lender of last resort, even though there were some disagreements between the staff and some European Directors on how clear that function should be. The report had laid out a factual account on what was clear in the treaties and what was not. Although the U.S. authorities did not agree with all the conclusions in the report, it was appropriate for the paper to highlight such issues.

Mr. Shaalan said that he agreed with Ms. Lissakers that in the event of a liquidity crisis in Europe there were still no clear guidelines for providing liquidity support. Immediately after the 1987 U.S. stock market crash, the U.S. Federal Reserve Bank had opened access to credit lines by the banks so that the banking system would not collapse. If a similar situation were to occur in Europe, their banking system would be facing some serious problems.

Ms. Lissakers noted that the timing of liquidity support was more important than who exactly was providing it. After the 1987 stock market crash, the U.S. Federal Reserve Bank's involvement had been hands on; numerous calls had been made to banks to lend to market players. However, in the event of similar occurrence in Europe, one wonders what the degree of responsiveness would be. Although there would always be a deliberate ambiguity about what kind of liquidity support would be available, it was important to highlight any uncertainties, in view of the transition of responsibility from national central banks to the ECB.

Mr. Donecker commented that EMU members were in general agreement that the national central banks were primarily responsible for providing liquidity support in the event of a crisis; however, one wanted to keep a certain amount of ambiguity with regard to whether it was the national central banks or the ECB who would intervene. The report had incorrectly implied that EMU members did not take that issue seriously. One had to be careful about making such judgments, especially as the ECB was in the process of being established.

Ms. Lissakers stated that in the past there had been significant divergences among EMU countries on the issue of liquidity support to banks, contrary to what Mr. Donecker had said. Although the EMU countries were currently sorting out their lender of last resort policy, that was not an argument for the Fund not to raise such issues in their reports. Moreover, even though European Directors seemed to be sensitive whenever a controversial issue regarding EMU was raised, it was the Fund's responsibility to raise such issues, provided that any factual disagreements were corrected.

Mr. Shaalan, referring to Box V-2 and other sections of the report, remarked that the paper was not passing judgment; it had only raised questions.

Mr. Donecker said that the report's conclusion on the issue of liquidity support had indeed included judgments. He believed that such issues should be reported in a balanced way, and that their presentation should be formulated carefully.

Mr. Fremann agreed with Mr. Donecker, and pointed out that the following sentence in the staff appraisal included a judgment: "Remaining capital market uncertainties are of a more medium-tem nature and include the impact of the euro on European financial markets and the adequacy of the new institutional infrastructure for managing systemic risk."

Mr. Kiekens said that he agreed with Ms. Lissakers that the staff should discuss the framework for providing liquidity in cases of systemic risk. The ECB's legal framework was flexible. However, the main issue was whether the ECB would function when needed, as such a situation had not been tested. Perhaps the ECB's governing council should prepare a crisis scenario, but that information should not be published. Of course, once the crisis scenario was applied, certain information would become public.

Ms. Lissakers disagreed with Mr. Fremann that that sentence in the staff appraisal was a judgement, as it did not imply that there were weaknesses with the new institutional framework, only that there were uncertainties.

Mr. Kiekens wondered whether the staff had discussed with the ECB whether they had set up a crisis scenario. At the time the ECB Treaty was drafted, the idea of a crisis scenario had been considered.

The staff representative from the Research Department pointed out that the idea of setting up a crisis scenario had been discussed with numerous market participants in Europe, as well as with the EMI, which was what the ECB was called at the time of the staff visit. Concerning the sentence in the staff appraisal that was referred to by Mr. Fremann, the staff had simply raised the issue, which was one of the purposes of the report.

Another staff representative from the Research Department stated that there were a number of opinions expressed by European Directors in their statements on the ECB's role as a lender of last resort. As noted in Mr. Kiekens's statement, the ECB had the necessary tools at its disposal to provide lender of last resort liquidity support in the event of a crisis. It also had the capability to limit the extent to which national central banks could provide liquidity support on their own; however, the ECB Council had not yet made a final decision on that issue . Although Mr. O'Donnell's statement had correctly stated that lender of last resort assistance was the responsibility of the national authorities, it seemed to be at odds with the ECB's ability to limit that discretion. Also, the Bundesbank was well known for not having a lender of last resort role. The Maastricht Treaty, the ECB Statutes, and other EU documents were consistent regarding the ECB's role as a lender of last resort. The main issue, however, was which mechanism would actually be used, not how the mechanism should be used. It was constructive to have some ambiguity, provided that such ambiguity did not raise uncertainty.

As crises could arise very quickly, it was essential that clearly defined responsibilities be established, the staff representative emphasized. There should be little ambiguity—at least among policymakers—about the crisis management roles between the ECB and the national central banks. Moreover, there should be a constant flow of information between the various national supervisors, the national central banks, and the ECB. However, the staff was concerned about the fact that the Maastricht Treaty said nothing about the ECB's access—or even obligation—to know anything about the financial conditions of its counterparts across the TARGET payment system. If such ambiguities had been clarified among European policymakers, perhaps the staff's concern had been somewhat exaggerated. However, there was no evidence of such an occurrence.

Mr. Donecker noted that the reason Mr. O'Donnell had a different view on the lender of last resort function of the ECB was that the United Kingdom was not a member of EMU. The ECB was responsible for EMU member countries only. It had sole responsibility for monetary policy—including providing liquidity support to help overcome a banking crisis. The national central banks were part of the ECB system; therefore, there was no ambiguity regarding the responsibilities of the ECB. However, information on when the ECB would consider intervening in the event of a crisis should not be made available to the general public. It would be beneficial if the staff were to form a united opinion on the lender of last resort issue, so that Directors would be able to agree or disagree with the staff's position. Mixed messages, such as stating that the ECB's crisis management role should be made more transparent, while stating that such information could be dangerous, should be avoided.

Mr. Shaalan wondered whether there was a correlation between implicit or explicit exchange rate guarantees provided by the state and a less ambiguous mechanism for the transmittal of liquidity to banks in a crisis situation.

The Economic Counsellor and the Director of the Research Department explained that when a central bank or other government agency acted as a lender of last resort, it provided two distinct functions: it was a general supplier of liquidity to the financial system in the event of a financial panic, which was what the Federal Reserve bank had done on October 20, 1987; and it was a specific supplier of liquidity to individual financial institutions when those institutions were facing liquidity problems. The Federal Reserve Bank had done that as well when one of the main New York City clearing banks had computer problems a few years ago, threatening a breakdown of the operation of the payment system. Certainly, when a central bank operated as a lender of last resort in either of those two circumstances, there was always a concern about moral hazard. When a central bank acted irresponsibly by providing blanket guarantees and by bailing out even deeply insolvent institutions on a regular basis,there were large moral hazard problems. That situation had occurred on many occasions. However, when a central bank acted as a well-disciplined and constrained lender of last resort, which meant lending in a crisis at a penalty rate on good collateral, then moral hazard problems—while not completely eradicated—were diminished.

In the paper Theoretical and Practical Aspects of Capital Account Liberalization (SM/98/197, 7/17/98), the staff had argued that most national governments had preferred that their central banks act as a lender of last resort to protect the financial system against systemic risks, but in a manner that did not generate substantial problems of moral hazard, the Economic Counsellor continued. The issue raised in the international capital markets report was that it was not clear to the staff or the public how the ECB would manage a crisis situation, especially as the national central banks had different practices concerning crisis management, and those practical differences had not yet been resolved. That might lead one to wonder whether there would be a mechanism in place that was capable of responding rapidly to contain a crisis. The recent events in Japan have underscored the importance of the central bank in staving off a major liquidity problem. In Europe, the national central banks would be providing a national safety net; however, how that mechanism would work was not entirely clear. As the European banking system evolved, perhaps there would be additional multilateral-based institutions, but that would cause more confusion about which central bank was responsible.

The Articles of Agreement stated that the Fund would oversee the international monetary system to ensure its effective operation, and that it would also oversee the compliance of each member with its obligations to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that did not tend to produce erratic disruptions, the Economic Counsellor remarked.As EMU would be the second most important monetary area in the world, the ECB's lack of clarity in the area of crisis management was an important issue for the international capital markets report to raise, especially if it were to be published. It was true that such issues were a matter of judgment; however, the staff would take responsibility for those judgments. If there were differences of view between the staff and members of the Board, those should be noted. Of course, any factual errors would need to be corrected. Directors, including their national authorities, were reminded that Article XII, Section 4(c) of the Articles of Agreement stated that "The Managing Director and the staff of the Fund, in the discharge of their functions, shall owe their duty entirely to the Fund and to no other authority." Each member of the Fund should respect the international character of that duty, and should refrain from influencing the staff in their discharge of those functions.

Mr. Kiekens agreed that the ECB should prepare a crisis scenario to ensure that there were clear understandings regarding the institutional framework among all parties. The staff should edit their message slightly to be more consistent with the statements made at that day's discussion.

Mr. Donecker agreed with the Economic Counsellor that Directors should not interfere with the staff's recommendations. However, if the report were made public, it would be under the name of the IMF, even though the report had been written by the staff of the IMF. Moreover, the general public would be aware that the Executive Board had discussed the report. If there were important points that were not correct, the Board shared that responsibility with the staff, along with management. Mr. Kiekens's suggestion to have Directors and staff look at those sections where differences existed should be followed. The message could be that the ECB should do more in the area of crisis management, and that there was an expectation that they would have something in place. The message should not be that the Europeans had a large information gap that needed to be filled because it threatened the international monetary system.

Mr. Taylor agreed that certain sections of the report should be redrafted, and he asked to be included in that process.

The Economic Counsellor and the Director of the Research Department noted that there should be a general understanding between the staff and the Board as to the proper procedures to be followed. A number of Directors had indicated that they had specific comments about sections dealing with individual countries, and the staff would try to reach a reasonable accommodation, particularly in cases where the staff had made factual errors. There were also issues of interpretation, especially in cases where the language was nuanced. In such circumstances, it would be appropriate to make a modification of the language. In cases where there were core disagreements between the staff and a Director or national authority, sometimes the convenient approach was to remove those passages from the document; that was a matter of judgment. If the core disagreements were—in the judgment of the staff—a matter of substantial importance, then the staff, with the approval of management, would keep those passages.

It was true that the international capital markets report was a Fund document, which meant that everyone—Directors, management, and staff—shared the responsibility, the Economic Counsellor continued. The primary responsibility, however, fell on the staff of the Research Department. One had to exercise caution when the views of the staff differed substantially from an authority or group of authorities who were themselves the subject of the surveillance. There could be a certain amount of moral hazard in that situation if one allowed the document to be overedited. As the Director of the Research Department, he had to pass judgment on those critical cases, and keep such passages even though one or a few Directors objected. On the issue of the proper role of the ECB concerning crisis management, one should be able to find language that would appropriately indicate that there were sufficient differences of opinion, and that it was an issue that had to be resolved. One had to strike the proper balance between the people that had the most direct interest in a particular issue, and the views of the rest of the Board.

Mr. Barro Chambrier made the following statement:

> We welcome the staff report on recent developments, prospects and policy issues in capital markets. It provides us with very useful background material for today's discussion, which is largely centered around the contagion and spillover effects of the Asian Crisis. It provides a good analysis of recent trends in capital flows from and to emerging markets. It also examines how mature markets behaved vis-a-vis the Asian crisis. We have also been gratified by the high quality of the preliminary statements produced for today's discussion. We wish to thank our colleagues for their contribution.
>
> I agree with Ms Lissakers that we have learnt a lot from the recent events. One has to realize that the inability of the domestic banking systems to handle capital flows, resulted in a decline in net capital flows to emerging market countries. It is probably too early to draw definitive lessons on the Asian crisis. However some preliminary observations may be useful. First, one of the key lessons is that strong banking systems are needed. This is also relevant for the membership of this institution. Indeed some of the countries from our constituency are already experiencing the spillover effects of the Asian crisis. This was illustrated during our last WEMD discussion with regard to the impact of the evolution of the commodity prices.
>
> At this stage it is critical for these affected East Asian countries to bring about a reversal of the net capital flows trend. This will require the implementation of wide-ranging reforms to strengthen financial systems and to accelerate the dissemination of best practices in financial sector regulations. I will refer here to the need for more transparency and accuracy of balance sheet operations, the strengthening of small financial institutions and the consolidation of offshore operations.

Second, we can also today safely say that among the factors that contributed to the deterioration of the situation in East Asia was the intention to keep interest rates low in order to assist the weak domestic financial institutions. Previous speakers already focussed on this point and I do not intend to elaborate further on it.

Third, another lesson is the need to involve the private creditor at an early stage.

Fourth, one important point that has contributed to some improvement in the financial situation of affected countries is the change in the perception, that the authorities are now more committed to the much-needed economic reforms. Here also the political factors play an important role for the timeliness of the necessary actions.

Looking ahead, the international community must develop mechanisms that will be used at an early stage to avoid the spread of financial crises elsewhere in the world. Such mechanism should include steps by the Fund and other multilateral institutions to strengthen financial supervisory and regulatory systems and sound corporate governance in the context of our surveillance exercise. These actions will contribute to an efficient intermediation of short term private capital flows worldwide. We recognize, however, that it will take a longer period to develop such systems in emerging countries. However, in the absence of strong systems countries will continue to be vulnerable to future crises.

On other issues related to capital movements towards and form emerging market countries, we wonder whether investors have tried to develop new markets since the onset of the Asian crisis. If not, what are the main factors that have prevented such a shift in regional emphasis?

Another point that can be derived from the staff paper is that there have been improvements in prudential regulations and supervision in Latin American countries since the Mexican crisis in 1994. In that context, we note on page 67 of the paper that the number of financial institutions fell in all countries except in Mexico between 1994 and 1997. We wonder what explains this development? Staff comments would be appreciated.

As regards developments and trends in the "mature financial markets", we note that the performance of these markets was not seriously affected by the Asian crisis. This has been due to the fact that these countries had a relatively small and well-provisioned bank exposure to the Asian emerging markets. However, Japan has been an exception among the mature financial markets. To address Japan's banking problems, a concentrated action is needed from the Japanese authorities.

In conclusion, there is no doubt that a swift improvement in Japan will be critical to the recovery of the Asian economy in general. At the same time a more global approach to the problem will have lasting and positive effects.

Mr. Luo made the following additional statement:

> Noting Mr. Palei's preliminary statement, he has raised a question about Hong Kong SAR, I have a few remarks to make. The October incident in Hong Kong is treated as a major event in the "second stage" of the Asian crisis in the staff report. As an international financial center and one of the most liquid markets in Asia, apparently, volatility in Hong Kong's financial markets may have a greater impact on other markets.
>
> In fact, it is difficult to judge how to divide the time frame into the first stage or second stage, in view of the continuum of events taking place in the second half of last year. There could be some degree of arbitrariness in this judgment. Following the float of the Thai baht in July, a Fund program was designed for Thailand in August but it only showed little effect. In early October, the Indonesian rupia was also affected by the contagion and the authorities sought help from the Fund. In mid-October, the currency of Taiwan Province of China devalued. As noted from the media report, this came as a surprise since Taiwan Province of China should have sufficient reserves to withstand the speculation The selling pressure on the Hong Kong dollar was then triggered by the sharp depreciation of the new Taiwan dollar of Taiwan Province of China, so the incident in Hong Kong is by no means the starting point of action.
>
> In fact, Hong Kong SAR has successfully withstood the speculative pressures, with the automatic stabilizer of the currency board mechanism. The speculation was not due to any macroeconomic policy failures. Hong Kong has a track record of strong monetary and fiscal discipline. Hong Kong's banking system is very strong and healthy. The system is also under prudent and close supervision.
>
> As speculators failed in their speculative attacks on the Hong Kong dollar, it is not surprising that they shifted elsewhere. While the incident in Hong Kong could have some contagion effect on other markets, this needs to be put in proper perspective.

The staff representative from the Research Department stated that the report had outlined the developments in Hong Kong SAR and Taiwan Province of China when it had described the chronology of events in the Asian crisis. It had not implied that the developments in those economies explained the contagion effect.

Another staff representative from the Research Department remarked that the events in Asia had highlighted the issue of capital controls. To correctly analyze such measures, it was important to keep in mind the state of the financial system of an economy, its type of institutional structure, and the quality of its policies. Many of the issues that needed to be considered were laid out in the forthcoming Research Department Executive Board paper on capital account liberalization.

The international capital markets report had focused on a fairly narrow set of issues concerning capital controls, the staff representative continued. It had analyzed situations where there had been surges in capital flows; and it stressed that capital controls were not an alternative to improving macroeconomic fundamentals or institutional reforms. The report had also focused on the types of capital controls, particularly market-based controls, which operated through price mechanisms rather than through quantity mechanisms. Certainly, as with any type of control, one had to consider both the short-term and long-term implications.

The main focus of the report had been on how to deal with large-scale unhedged foreign currency exposures of the corporate sector in many of the Asian economies, the staff representative noted. Those exposures had differentiated the Asian crisis from the earlier crises in the 1980s or the Mexican crisis, although there had been some evidence—albeit small—of that feature in the Mexican crisis. The exposures were on both an on-balance-sheet and off-balance-sheet basis. In the case of exposures on an off-balance-sheet basis, it had become evident that corporates had taken a position on the sustainability of the exchange rate arrangements in the Asian crisis countries. Corporations had been faced with a situation where there had been significant interest rate differentials in terms of borrowed funds, with lower interest rates in the offshore markets. Creditors abroad had been interested in investing in what they regarded as the most dynamic firms in very successful economies. In a number of countries, there had also been an expectation that the authorities would maintain the exchange rate arrangements that were currently in place—primarily fixed rates or rates with limited rates of depreciation. The buildup of such corporate positions had a strong impact on the dynamics of the crisis and on the turmoil in foreign exchange markets. Once the corporates had realized that the exchange rate arrangements were unlikely to be maintained, and that they had to hedge the positions that they had taken, they were left with only one vehicle for hedging, in view of the absence of other type of derivatives products: to accumulate foreign exchange. That had led to a corporate panic. The foreign exchange market had become one-sided, as all corporates had tried to acquire foreign exchange. That had created extraordinary pressures on the exchange rates in a number of the Asian countries.

What was needed was large-scale restructuring of corporate debt positions, as it was unlikely that the credit process in a number of the Asian countries would return to normal until that occurred, the staff representative explained. The restructuring process was just beginning in those economies, and that process would be very costly.

The main challenge that had arisen before the Asian crisis had been what to do in the face of large capital inflows, the staff representative stated. The medium-term answer was to set up an institutional framework that encouraged market discipline, such as good accounting practices with appropriate disclosure requirements in the corporate sector, rules governing corporate governance, and efficient bankruptcy procedures that could be implemented by a judicial system that was equipped to handle such problems. As the events in Asia had shown, such institutional arrangements were unfortunately not in place in many emerging markets owing to the fact that they were costly and time consuming to implement. As Mr. Taylor had noted, without such an institutional framework, price distortions and inappropriate incentives would arise, regardless of what exchange rate structure or macro policies one had in place. Nonetheless, unstable macroeconomic policies would exacerbate the degree of distortions. If the institutional framework were not present, there were a number of policy actions that one could take. First, one could just let the surge of capital inflows occur; however, the Asian experience had shown that that particular approach was very costly and disruptive. Second, one could attempt to implement structural reforms as quickly as possible, particularly in the judicial area. However, it might be difficult to implement those structural reforms in a timely manner. As a third alternative, the paper had discussed the potential use of Chilean-type controls that operate through market mechanisms to raise the price of external borrowing by the corporate sector to avoid excessive accumulation of external debt, the staff representative stated. However, that issue would be discussed in more detail at the forthcoming meeting on capital account liberalization.

The Acting Chairman made the following concluding remarks:

Executive Directors held a wide-ranging discussion of developments and prospects in the international capital markets, with particular emphasis on the lessons from the Asian crisis, the risks and challenges facing policy makers at the current juncture, and issues raised by the forthcoming introduction of the euro. They commended the staff for the comprehensive and informative papers prepared for the Board meeting.

Directors focused most of their attention on the Asian crisis. They considered the deep-seated problems in banking systems and financial sectors, including weak supervisory and regulatory systems, poor internal risk management, and governance problems, as significant factors—although not the only ones—that had led to the crisis. In the view of several Directors, inadequate domestic market discipline owing to extensive national safety nets had encouraged excessive risk taking in a number of countries. According to Directors, the financial sector weaknesses implied that the large capital inflows prior to the crisis had not been efficiently intermediated and—in conjunction with excessive reliance on formal or informal exchange rate pegs—had led to significant unhedged exposures to currency and interest rate risk, liquidity mismatches, and poor credit quality.

Regarding the role of different investors during the crisis, Directors noted that attempts by domestic agents to hedge or unwind unhedged currency exposures—as well as, in some cases, capital flight—had been an important source of pressure in exchange markets, although they expressed different views about the role that international investors and hedge funds had played in the crisis. Directors noted that the very large exchange rate depreciations during the crisis had been exacerbated by an especially perverse set of market dynamics related to the drying up of liquidity in foreign exchange markets, growing counterparty risk, and interactions with weak domestic financial institutions. Several Directors noted that the extent of spillovers and contagion across countries did not appear to be fully accounted for by the growing trade and financial linkages between countries. Several Directors suggested that contagion had been aggravated by deficiencies in information and lack of transparency that had made it difficult for investors to discriminate between different emerging markets, and had contributed to the severity of the "wake-up" call after the crisis had begun.

A number of Directors suggested that the Asian crisis raised fundamental questions about the functioning of international capital markets. Directors noted that the capital inflows prior to the crisis had created enormous difficulties for emerging market policy makers, given their size and the potential for sharp reversals when sentiment changed. In the view of some Directors, the Asian crisis was as much a reflection of weaknesses in international investor behavior as of problems in the emerging markets. Some

Directors considered that the sharp decline in nominal interest rates in mature markets had stimulated the search by global investors for higher yields. In this regard, a number of Directors noted, as an important feature of the crisis, cross-border interbank lending—especially at short maturities—which had facilitated capital inflows and posed new challenges in managing risk. A number of Directors expressed support for changes to bank capital requirements that would better reflect the risks of short-term interbank lending. Some Directors underscored the need to find ways to improve the pricing of risks by foreign creditors, and also called for better supervision of creditor banks. Several Directors also noted that key international credit rating agencies had failed to foresee the Asian crisis, and had then aggravated it when they subsequently moved to sharply lower the credit ratings of countries. It was noted by a number of Directors, however, that these agencies had not been alone in not seeing the crisis coming, or in missing the extent of the vulnerabilities in the Asian crisis countries. Notwithstanding these concerns, Directors noted that the trend toward increased capital account liberalization was inevitable. In the view of most Directors, a certain degree of volatility was unavoidable, and policy makers had to work to make their economies more resilient to the shocks that did occur, and much greater attention was needed to ensure the orderly and well-sequenced liberalization of the external capital account.

Directors pointed to a number of lessons that national authorities should take from the Asian crisis. Most importantly, they noted that weak financial policies and systems could overwhelm sound macroeconomic policies. A number of Directors suggested that exchange rate flexibility could play a key role both in helping to adjust to capital inflows and in encouraging appropriate hedging. Some Directors reiterated that the timing of exiting from a peg was crucial. In particular, the risks of switching to a flexible system in the midst of the crisis are increased when banking, financial, and corporate sectors are weak. A few Directors argued that other options in the context of the Asian crisis might have been an adjustment in the level of the exchange rate within the framework of the existing anchor, or moving to another nominal anchor. Directors agreed that a key to avoiding future crises was to strengthen banking sector supervision and infrastructures, including through the adoption of the principles set out by the Basle Committee. Some Directors favored the use of Chilean-type taxes on short-term capital inflows as a prudential measure applying to both the bank and nonbank sectors. Several other Directors, however, considered that, while such controls had helped discourage potentially destabilizing short-term flows in certain cases, they tended to lose effectiveness over time; they had helped to gain time for countries that were in the process of building up their supervisory frameworks and strengthening market discipline. In any event, they should not be considered as a substitute for strong fundamentals, including the requisite banking sector reforms. Some Directors pointed to the important role of foreign direct investment as a more stable source of financing. Several Directors commended efforts by a number of countries to facilitate the development of local capital markets, especially bond markets, to reduce the importance of banks in intermediating capital flows. On the issue of moral hazard, some Directors agreed that the prospect of Fund support had probably not been a consideration in lenders' and borrowers' decisions prior to the Asian crisis; however, several Directors noted that the provision of Fund support, together with government guarantees on external liabilities, could have affected the behavior of market participants. In that context, they called for measures to minimize moral hazard, including by early involvement of the private sector, to bring about fair burden sharing between the private and public sectors.

With respect to more recent developments in the emerging markets, Directors noted with concern the sharp output declines in the Asian crisis countries and the continued fragility of private market financing provided to the emerging markets. There was agreement among Directors that the priority in the Asian crisis countries was the acceleration of financial and corporate restructuring, including provision of adequate bankruptcy procedures, which could be facilitated in some cases by the judicious use of public funds to recapitalize weak but viable financial institutions. More generally, they urged policy makers in the emerging markets to continue their efforts to reduce vulnerabilities to external shocks, including through addressing domestic macroeconomic and financial weaknesses and, in the case of commodity exporters, adjusting as appropriate to the softness in commodity prices.

Directors noted the sharp contrast between the continued weaknesses evident in a number of emerging markets, especially in Asia, and the relatively favorable performance of many of the industrial countries. On the one hand, the favorable performance of the industrial countries in North America and Europe was seen by most Directors as reflecting strong macroeconomic conditions and policies in many of these countries, an environment of generally low and stable inflation, and small and relatively well-provisioned exposures of many banking systems to the Asian emerging markets in crisis. Moreover, several industrial countries had benefited to some extent from a flight to quality, and the favorable inflation implications of lower commodity prices and weaker Asian economic activity. On the other hand, growing domestic weaknesses in Japan had been exacerbated by—and were themselves contributing to—the Asian crisis, given close trading and financial linkages with the Asian emerging markets. Directors welcomed the growing confidence in the successful launch of the euro at the beginning of 1999, and the high degree of macroeconomic convergence achieved by the eleven countries that were to comprise the initial euro area, which was seen as contributing importantly to intra-European exchange rate stability and the effective convergence of long-term interest rates at low levels.

Directors noted a number of not insignificant risks in the mature economies that made the current outlook especially uncertain. Most significantly, the failure of Japan to decisively address its financial sector problems had contributed to domestic economic weakness, downward pressure on the Japanese yen, and adverse spillovers, in particular, to neighboring emerging markets and the world economy. They therefore strongly urged the new Japanese administration to move quickly to address the long-standing weaknesses in the banking sector through a rigorous accounting of the size of the bad loan problem, recapitalization and restructuring of viable banks, and improvements in the prudential framework to ensure that any use of public funds in assisting the banking sector result in a sustained improvement in the safety and profitability of the banking system. A number of Directors noted that Japan's "Big Bang" reforms added to the urgency of action, since the reforms would place additional pressure on banks and contribute to further downward pressure on the yen by making it easier for Japanese savings to be invested abroad.

A number of Directors expressed concern about the risk of a significant correction in the current high equity valuations in the United States, particularly in view of the apparent slowdown in U.S. earnings growth, the likelihood of further fallout from Asia, and the possibility of an increase in U.S. interest rates. Most Directors were of the view that the strong fundamentals in the United States— together with improvements in financial market infrastructure since the 1987 crash—meant that a modest correction would be manageable from a domestic perspective. They expressed concern, however, about spillovers, especially to emerging equity markets, and possible adverse implications for confidence in the current unsettled environment.

Directors noted that the European Economic and Monetary Union (EMU) process had highlighted a number of supervisory and regulatory issues for the European countries that were also, in varying degrees, faced by other countries. Directors argued that the acceleration of financial sector restructuring that was likely to be facilitated by the introduction of the euro would pose a number of challenges for European policy makers. Directors expressed a diversity of views on the preparations for crisis management within EMU, and in particular on lender of last resort support. Some Directors noted that lender of last resort support was the responsibility of national authorities. Others thought that it was essential for a central bank, and, in particular, for the European Central Bank (ECB), to be the lender of last resort, and for it to play a central role in coordinating supervision across pan-European institutions and markets. Some Directors also pointed to the important role that needed to be played by financial safety nets, such as deposit insurance schemes, liquidity consortia, and treasuries. Some Directors acknowledged, by referring to the European System of Central Banks (ESCB) Statute, that the ESCB had the tools necessary to fulfil a liquidity support role and could step in to provide liquidity if and when it were needed. Some Directors supported the staff's suggestion that a further clarification of the sharing of responsibilities between the ECB and national central banks and the flow of information between national supervisory bodies and the ECB was important. There was also a diversity of views expressed about the features of the new pan-European TARGET payments system. Some Directors thought that improvements could be made to operational aspects of TARGET, including pricing, to make it more competitive, and that this would indeed occur as experience is gained with the new payments system. Other Directors expressed the view that competition between TARGET and other payments systems with similar risk management characteristics was not to be discouraged. More generally, Directors welcomed the ongoing efforts in multilateral fora and in many mature market countries to improve supervision and regulation through improvements in accounting and disclosure, clearer understandings on the responsibilities of "home" and "host" supervisors, and an increased focus on consolidated, risk-based supervision, such as the Basle Committee's recent guidelines on market risk capital requirements.

Directors concluded by noting that developments since the previous International Capital Markets exercise had underscored the importance of timely and comprehensive surveillance of international financial markets. Directors generally welcomed the forthcoming publication of the 1998 International Capital Markets Report—after incorporation of appropriate revisions reflecting the discussions of the Executive Board—as an important vehicle for the dissemination of the staff's work on multilateral surveillance.

3. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. O'Donnell on the completion of his service as Executive Director for the United Kingdom.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/83 (7/29/98) and EBM/98/84 (7/31/98).

4. RULES FOR 1998 REGULAR ELECTION OF EXECUTIVE DIRECTORS—REPORT AND DRAFT RESOLUTION

1. The Executive Board decides that no change in the terminal date, namely, July 31, be made for the purpose of calculations under Article XII, Section 3(c) for the 1998 Regular Election of Executive Directors.

2. Pursuant to Section 13 of the By-Laws of the Fund, the Board of Governors is requested to vote without meeting upon the draft Resolution entitled "1998 Regular Election of Executive Directors" set forth in Attachment I to Annex I of EBD/98/79 (7/22/98).

3. The Secretary is directed to send the "Report of the Executive Board to the Board of Governors on the 1998 Regular Election of Executive Directors" in Annex I of EBD/98/79 and the draft Resolution entitled "1998 Regular Election of Executive Directors" to each member of the Fund by mail or other rapid means of communication on or before July 31, 1998.

4. To be valid, votes must be cast by Governors or Alternate Governors on or after July 31, 1998, and must be received at the seat of the Fund at or before 6 p.m. Washington, D.C. time on August 31, 1998. Votes received after that time will not be counted.

5. If passed, the effective date of the Resolution of the Board of Governors shall be August 31, 1998, the last day allowed for voting.

6. All votes cast pursuant to this decision shall be held in the custody of the Secretary until counted, and all proceedings with respect thereto

shall be confidential until the Executive Board determines the result of the vote.

7. The Secretary is authorized to take such further actions as he shall deem appropriate in order to carry out the purposes of this decision. (EBD/98/79, 7/22/98; and Sup. 1, 7/27/98)

Decision No.11772-(98/84), adopted
July 30, 1998

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by an Advisor to Executive Director, and by an Assistant to Executive Director as set forth in EBAM/98/134 (7/29/98) is approved.

APPROVAL: December 13, 1999

SHAILENDRA J. ANJARIA
Secretary