REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

As explained in Chapter 1, the international community, under U.S. leadership, has proposed a set of reforms to strengthen the international financial system. These reforms, designed to reduce the incidence of future crises, are referred to collectively as the “new international financial architecture.” Their aim is to create an international financial system for the 21st century that captures the full benefits of global markets and capital flows, while minimizing the risk of disruption and better protecting the most vulnerable groups in society. The work accomplished toward these goals in 1998 was only the latest stage in an evolutionary process that has been under way for some years.

FROM THE HALIFAX SUMMIT TO THE G-22 REPORTS

A broad debate on the steps needed to strengthen the international financial system was already under way when the Mexican peso was devalued suddenly in December 1994. The ensuing crisis, however, gave the debate considerable impetus and pertinence. The annual summit of the leaders of the Group of Seven (G-7) nations (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) in 1995, held in Halifax, Nova Scotia, initiated work in a number of areas. One such area was additional study of means to promote the orderly resolution of future financial crises. The finance ministers and central bank governors of the G-10 countries were asked to review a number of ideas that might contribute toward that objective. The G-10 (which actually has 11 members: the G-7 plus Belgium, the Netherlands, Sweden, and Switzerland) established a working party, which submitted a report—informally known as the Rey Report, after the chairman of the working party—to the ministers and governors in May 1996.

The report noted recent changes in financial markets that, in some cases, have altered the characteristics of currency and financial crises in emerging markets. It indicated that neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences in the event of a crisis. It also called for better market-based procedures for the workout of debts when countries and firms are in financial distress. Reforms of bond contracts were proposed to encourage the cooperation and coordination of bondholders when the financial distress of a country or a corporation requires the restructuring of the terms of a bond. The report also suggested a review of IMF policies on “lending into arrears” to extend the scope of this policy to include new forms of debt. Such policies would allow the IMF to continue lending, in certain unusual and extreme circumstances, to countries that had temporarily suspended debt-service payments but
continued to maintain a cooperative approach toward their private creditors and to comply with IMF adjustment policies.

A number of important innovations came out of this reform process: the development of international standards for making economic data publicly available (under the IMF's Special Data Dissemination Standard); international standards for banking supervision (the Basle Core Principles for Banking Supervision); the decision to expand the IMF's backup source of financing under the New Arrangements to Borrow (25 participants in the NAB agreed to make loans to the IMF when supplementary resources are needed to forestall or cope with an impairment of the international monetary system, or to deal with an exceptional situation that poses a threat to its stability); and, more recently, a new financing mechanism in the IMF, called the Supplementary Reserve Facility, to help members cope with a sudden and disruptive loss of market confidence, but on terms designed to encourage early repayment and reduce moral hazard.

Despite some progress in strengthening the system, the eruption of the Asian crisis in 1997 demonstrated the importance of considering further questions regarding the operation of the international system. In November 1997, on the occasion of the Asia-Pacific Economic Cooperation leaders' summit in Vancouver, a number of Asian leaders proposed a meeting of finance ministers and central bank governors to discuss the crisis and broader issues. They suggested that participation in the meeting be expanded to include emerging market countries, not just the usual small number of major industrial countries. The President responded by calling on the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System to convene such a meeting. Finance ministers and central bank governors from 22 systemically significant countries in the international financial system (informally dubbed the Group of 22, or G-22) gathered in Washington on April 16, 1998, to explore ways to reform the system that could help reduce the frequency and severity of crises. Three working groups were formed to consider the following three sets of issues: measures to increase transparency and accountability, potential reforms to strengthen domestic financial systems, and mechanisms to facilitate appropriate burden sharing between official institutions and the private sector in time of crisis. The three working groups presented their reports in October 1998 on the occasion of the annual meetings of the IMF and the World Bank.

GREATER TRANSPARENCY AND ACCOUNTABILITY

The report of the first working group reflects the existence of a broad consensus on the need for greater transparency not only by the private sector and national authorities but by the international financial institutions (IFIs) as well. The Asian crisis made clear once more that it is important for countries to provide sufficient information.
about their macroeconomic and financial conditions. The information needed includes data on the size, maturity, and currency composition of external liabilities, as well as accurate and comprehensive measures of the level of foreign exchange reserves. The crisis also underscored the need for banks and corporate enterprises to provide accurate information about their financial accounts. Without such information, outsiders cannot adequately assess the true financial condition of governments and firms. The crisis made clear as well the importance of transparency on the part of the IFIs themselves, and led to calls for the IMF and other IFIs to be more open about their activities, economic analysis, policy advice, and recommendations.

The report of the G-22 working group on transparency and accountability recommends that national authorities publish timely, accurate, and comprehensive information on the external liabilities of the financial and corporate sectors in their countries as well as their own foreign exchange positions. Published information on official foreign exchange positions would extend to both reserves and liabilities, for example those deriving from government intervention in forward exchange markets. The report recommends adherence to existing international standards for transparency and finds that standards in additional areas, including monetary policy and accounting and disclosure by private financial institutions, might be useful. The report calls for better monitoring of countries’ compliance with such standards, including through IMF reporting on countries’ adherence to internationally recognized standards. It also recommends that the potential for greater transparency of the positions of investment banks, hedge funds, and institutional investors be examined.

Finally, the report calls on the IMF and the other IFIs to be more open and transparent. Accountability, it argues, is important for all institutions, and unnecessary secrecy would be particularly inappropriate in institutions that are telling others to be more transparent. For example, the report recommends that IFIs adopt a presumption in favor of the release of information, except where confidentiality might be compromised. It also calls for publication of program documents, of background papers to reports following the regular yearly visit by the IMF to a member state, of public information notices following the IMF Executive Board’s discussion of reports on member countries’ economic conditions, of retrospective program reviews, and of other policy papers.

Increased transparency can help prevent the buildup of countries’ financial and macroeconomic imbalances. In the Asian crisis, for example, more information concerning the external debt of firms and banks might have limited investors’ willingness to lend to such institutions in the first place. Transparency can also encourage more timely policy adjustment by governments and help limit the spread of financial market turmoil to other countries by enabling investors to distinguish
countries with sound policies from those with weaker policies. Nonetheless, transparency alone is unlikely to be sufficient to prevent another major crisis from occurring. In Asia, greater transparency about net reserves and offshore liabilities of the financial and corporate systems might well have helped attenuate the crisis. But investors also missed many warning signals in data that were widely available. More is needed than just information.

REFORMING AND STRENGTHENING DOMESTIC FINANCIAL INSTITUTIONS

As discussed in Chapter 6, weaknesses in the financial sectors of borrowing countries now appear to have been a central cause of the Asian crisis, and of some previous financial crises as well. Commercial banks and other financial institutions borrowed and lent imprudently, channeling funds toward projects that were not always profitable. Insufficient expertise and resources in countries' regulatory institutions led to weak regulation of the financial system, and in particular to lax supervision of banks. Insurance of bank deposits was either implicit or poorly designed. Often, governments did not provide explicit deposit insurance; rather, they implicitly insured the liabilities of the banking system. Connected lending was widespread: banks and other financial firms in a business group would make loans to other firms in the group without objectively evaluating or monitoring their soundness. The result was often distorted incentives for project selection and monitoring. All these factors contributed to the buildup of severe structural weaknesses in the financial system, the most visible manifestation of which was a growing level of nonperforming loans. The growing supply of funds from abroad, facilitated in part by capital account liberalization, only heightened the problem; rising capital inflows combined with poorly regulated and often distorted domestic financial systems to create a dangerous environment.

Strengthening domestic financial systems, the focus of the second G-22 working group, will thus be a central element of ongoing systemic reform. The list of measures required is long and will take years to complete. The reforms recommended by the G-22 report include the development of liquid and deep financial markets, especially markets in securities (bonds and equities). Financial markets should be able to rely on strong prudential regulation and supervision of banks and other financial institutions, based on the Basle Core Principles of Banking Supervision and the Objectives and Principles of Securities Regulation set out by the International Organization of Securities Commissions. Appropriate restrictions on connected lending would be beneficial. The working group's report also calls on countries to design explicit and effective deposit insurance mechanisms to protect bank depositors. The report also calls for better corporate governance in both the financial sector and the nonfinancial sector, so that investment
decisions respond to market signals rather than to personal relationships. It further recommends the design and implementation of bankruptcy and foreclosure laws for insolvent firms and, more broadly, the implementation of efficient insolvency and debtor-creditor regimes, possibly including procedures for systemic bank and corporate restructuring and debt workouts for corporations in financial distress. Finally, the report advocates better coordination and cooperation among international organizations and international supervisory entities in strengthening financial systems, as well as increased technical assistance for and training of government officials and regulators.

**BETTER CRISIS RESOLUTION, INCLUDING APPROPRIATE ROLES FOR THE OFFICIAL COMMUNITY AND THE PRIVATE SECTOR**

Although strengthening financial systems may prevent some crises from occurring and make those that do occur less virulent, it cannot be expected to eliminate them altogether. It is therefore essential to establish means of minimizing the depth and severity of crises without undermining appropriate incentives for prudent private and public behavior. This very important task constitutes the third and final pillar of the set of international financial reforms proposed in October by the G-22 working groups.

The G-22 report on this topic identifies policies that could help promote the orderly resolution of future crises, including both official assistance and policies and procedures that could facilitate the involvement of the private sector as appropriate. It noted that recent events have highlighted how the larger scale and greater diversity of recent capital flows to emerging markets generate the risk that crises can erupt more quickly and can be larger in scope than in the past. It is of critical importance that the IMF and the other IFIs remain capable of catalyzing policy reform and the restoration of market confidence in their member countries in the event of an international financial crisis, in the context of a strong program of policy adjustment. The combination of adjustment and financing should be sufficient to resolve most payments difficulties. However, the scale of private capital flows significantly exceeds the resources that the official community can reasonably provide, even with the quota increase to bolster IMF resources and other measures. Moreover, the perception that sufficient official financial assistance may be made available to allow a country to meet all contractual obligations without some form of appropriate private sector involvement might distort the incentives of both creditors and debtors. It may encourage some creditors to take unwarranted financial risk, some debtor countries to follow inappropriate policies, and both debtors and creditors to underestimate the risks they are assuming. Although the international community will continue to provide assistance—conditioned on economic reform—to deal with the prob-
lems that have given rise to crises, mechanisms are needed to allow
the private sector to participate constructively in containing crises
and resolving them over time. Work is under way to find constructive
and cooperative ways to “bail in” private investors.

New procedures suitable to modern markets might be usefully de-veloped for effective management of the financial difficulties of both firms
and countries. When banks accounted for the majority of international
capital flows, as in the 1970s and 1980s, troubled debtors could more
easily resolve a crisis through joint negotiations with a small number
of banks and the IFIs. Negotiations such as those developed to address
the 1980s debt crisis entailed agreements to postpone debt repay-
ments (debt restructuring) and occasionally to reduce the overall value
of the obligation (debt writedown). However, the recent proliferation of
creditor institutions and instruments and the growth of international
bond markets have made it harder to coordinate the actions of credi-
tors during a crisis. Unilateral actions by troubled debtors are, on the
other hand, highly disruptive and can lead to contagion, if they
increase investors’ concern that other countries may follow suit. This
might explain why Russia’s unilateral debt restructuring in August
1998 disrupted markets as far away as Latin America.

Recognizing the need for new procedures, the G-22 report includes a
number of recommendations. First, it calls for a range of policies to
help prevent crises and limit the severity of those that do occur. The
report emphasizes that countries might want to limit the scope of gov-
ernment guarantees, including those covering the liabilities of finan-
cial institutions, and to make explicit those guarantees that are offered
and price them appropriately (for example, through effective deposit
insurance). In addition, the report endorses the development of innov-
ative financing techniques to permit increased payment flexibility,
greater risk sharing among debtors and creditors, or the availability of
new financing in the face of adverse market developments such as sud-
den reversals of capital flows. For example, debt contracts calling
explicitly for repayments contingent on the prices of key primary com-
modities could automatically reduce countries’ debt burdens when
prices move against them.

Finally, the report identifies key features of effective insolvency and
debtor-creditor regimes (including bankruptcy, restructuring, and fore-
closure laws) and highlights the role of such regimes in contributing to
effective crisis containment and resolution. Workable procedures in these
areas may be useful to encourage the prompt recovery of economic activ-
ity following a financial crisis. Among the most important basic objectives
of an insolvency regime are to maximize the value of a firm’s assets after
its liquidation or reorganization; to provide a fair and predictable regime
for the distribution of assets recovered from debtors; and to facilitate
the uninterrupted provision of credit for commercial transactions by
providing an orderly regime for the distribution of debtors’ assets.
Other measures recommended by the working group would encourage the coordination of creditors in the event of a crisis. Following the recommendations of the 1996 Rey Report, the G-22 report proposes the inclusion of creditor coordination clauses in bond contracts. These clauses would be designed to create an environment in which all parties—creditors, debtors, and IFIs—can work together to resolve crises in the most advantageous manner possible. Collective action clauses in bond contracts could help overcome the problems to which a large number of creditors inevitably gives rise. For example, a clause allowing for the collective representation of creditors (such as through the formation of a creditors’ committee) can help facilitate coordinated action among a large group of creditors. A majority action clause could prevent a small minority of creditors from impeding a debt-restructuring agreement, by allowing a qualified majority of creditors to alter the payment terms of the debt contract. Currently, most sovereign bond contracts in the United States require unanimity to restructure the terms of the contract. Similarly, sharing clauses would mandate the equal treatment of creditors by imposing a fair division of payments among them. This could discourage disruptive legal action and preferential settlements that benefit a few creditors at the expense of others.

The report also calls for new methods of crisis management in the extreme case of a temporary suspension of debt payments. Recent experience (as in Russia in 1998) underscores the fact that such suspensions and unilateral restructuring actions can be highly disruptive, especially if they substitute for policy reform and adjustment. The G-22 report argues that countries should not, and normally would not, suspend debt payments (interest and principal) until all other reasonable alternatives have been exhausted. However, suspension might occur in exceptional cases, in the event of severe and unanticipated adverse market developments. In these cases, the report emphasizes the importance for countries to rely on orderly and cooperative approaches, rather than unilateral actions, in negotiating the restructuring of contractual obligations. Unilateral action may entail significant economic and financial costs.

If a country does suspend its debt payments to private creditors, it is technically in arrears. The report argues that, in those exceptional cases when a country experiences a severe crisis and a temporary payments suspension cannot be avoided, the international community and private creditors may still have an interest in providing incentives for strong and sustained policy adjustments and structural reform. It therefore suggests that the international community can signal its conditional willingness to provide financial support, under appropriate conditions, even if a country has imposed a temporary payments suspension. The report argues that such official support should be provided only if the decision to suspend payments reflects the absence of rea-
sonable alternatives, if the government is willing to undertake strong policy adjustment, and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country’s payments difficulties. An IMF policy of lending to a country that has not yet completed negotiations with private creditors, but is negotiating cooperatively and in good faith, is referred to as “lending into arrears.”

A final set of recommended measures would facilitate prompt and orderly debt workouts. As outlined above, the orderly resolution of crises will require a combination of official finance, in the context of strong policy adjustment programs, and appropriate private sector involvement. Financial crises are often associated with significant financial distress in the banking and corporate sectors. Although national insolvency regimes (such as bankruptcy and corporate restructuring laws) are intended to provide an appropriate legal and institutional framework for the restructuring of corporate debt, corporate sector crises may occasionally achieve sufficient scale to threaten the solvency of a country’s entire financial system, as happened in the Asian crisis.

Several measures can be undertaken to facilitate the orderly workout of the liabilities of firms in distress. One such measure is available in domestic insolvency regimes—such as corporate restructuring under Chapter 11 of the U.S. bankruptcy code—that allow distressed firms to obtain new, senior credits to ensure their ongoing operation during the restructuring of their debt. (Seniority means that the new lenders will be first in line for repayment. Without such assurance, new lenders are unlikely to come forward.) Analogously, in the international context, the report suggests that the development of better means of encouraging the private sector to provide new credits, in the event of a debt crisis or suspension of debt payments, should be considered. Otherwise, loans for basic purposes, such as working capital for production and exports, can become unavailable. In certain circumstances the government may also find it useful to develop a framework for encouraging out-of-court negotiations between private debtors and their creditors. International support can be harnessed to support restructuring efforts as well. For example, one goal of the Asian Growth and Recovery Initiative, recently launched by the United States and Japan, is to support the implementation of more comprehensive and accelerated restructuring of banks and corporations in the crisis-afflicted countries in Asia.

Implementation of the international financial architectural reforms proposed in the G-22 reports will take time. But they also promise to reduce the likelihood of future crises and the severity of those that do occur. For its part, the G-7 strongly signaled its commitment to implement many of the reforms proposed by the working groups in its October 30 declaration, a subject considered next.
ADOPTION OF MEASURES TO REFORM THE INTERNATIONAL FINANCIAL ARCHITECTURE

The release of the G-22 reports was followed by detailed discussions among the G-7 finance ministers and central bank governors and with officials from other industrial and emerging market economies. The G-7 ministers and governors agreed, in a statement issued on October 30, 1998, on specific reforms to strengthen the international financial system. In the words of their communiqué, they:

agreed to carry these forward through our own actions and in the appropriate international financial institutions and forums. These reforms are designed to: increase the transparency and openness of the international financial system; identify and disseminate international principles, standards and codes of best practice; strengthen incentives to meet these international standards; and strengthen official assistance to help developing countries reinforce their economic and financial infrastructures. They also include policies and processes to ensure the stability and improve the surveillance of the international financial system. Finally, they aim at reforming the International Financial Institutions, such as the IMF, while deepening cooperation among industrialized and developing countries.

FURTHER STEPS TO STRENGTHEN THE INTERNATIONAL FINANCIAL ARCHITECTURE

In their October 30 statement, the G-7 countries committed themselves to a number of reforms consistent with the recommendations of the G-22 working groups, as well as a great deal of additional analysis and research. The G-7 also stressed the need for the international community to widen its efforts to strengthen the international financial system. The G-7 thus committed themselves to initiate further work in a number of other important areas to identify additional, concrete steps to strengthen the international financial architecture. These include:

- examining the additional scope for strengthened prudential regulation in industrial countries
- further strengthening prudential regulation and financial systems in emerging markets
- developing new ways to respond to crises, including new structures for official finance and new procedures for greater private sector involvement in crisis resolution
- assessing proposals for further strengthening of the IMF