

## Improving the International Monetary System

### 7.1 Introduction: strengthening the system by prevention and crisis management

No matter how well the suggestions of the previous sections are taken to heart and thus no matter how well the macroeconomic policy framework is constructed in liberalising economies, mistakes are made; and no matter how well policies are conducted, there will remain the possibility of adverse external developments. Countries opening themselves to international financial markets – and their governments – run risks of things turning out badly. Policy mistakes, domestic political developments, or external circumstances can lead to crises and the withdrawal of funds previously attracted by investment opportunities of the kind described earlier. The most recent example of this is the Mexico crisis of winter 1994-95. But, as discussed earlier in this report, there were similar problems in the debt crises of the early 1980s, after the massive growth of lending to emerging markets in the 1970s. Similar problems occurred in the early 1930s, after the growth in lending to the peripheral economies in the 1920s. Similar crises were also a feature of the late 19th century, as metropolitan markets expanded into the colonial periphery.

The purpose of this section is to ask whether, and to what extent, the strengthening of the international system – as distinct from the better national policies – can (i) help reduce the risk of such crises occurring (prevention); and (ii) help minimise the damage caused if and when they do occur (containment). Globalisation of markets increases the chance that problems in one part of the world will have contagion effects on other countries. Cooperative and coordinated preven-

tion and containment might be required for this reason.

Under the general heading of prevention, we will consider improved information provision, IMF leverage through policy advice and assistance, improved central bank cooperation, and also proposals to tax international money flows (the ‘Tobin tax’).

Under the heading of containment we consider responses to the two forms of crises to which sovereign governments are potentially exposed – namely crises of illiquidity and crises of insolvency. We discuss each of these in some detail. In principle as well as in practice, illiquidity and insolvency are much harder to distinguish for sovereign debtors than for firms, and policy must recognise the inherent ambiguity and its implications. The Group of Ten issued a report in May 1966 on dealing with liquidity crises, entitled ‘The Resolution of Sovereign Liquidity Crises’. It can be argued (*Financial Times*, 16 May 1966) that ‘[as] far as they go, the proposals will probably help’, but that ‘the suggestions, while sensible, are too modest to have much impact on the resolution of future financial crises’. Earlier, Eichengreen and Portes had (1995) offered some detailed practical reform proposals. In this Chapter we will revisit those proposals in the light of the G10 document.

### 7.2 Prevention

#### 7.2.1 International responses involving improved information provision

In 1995 the IMF Executive Board agreed on a list of indicators to be provided by countries to the IMF on a regular and continuous basis. These include, as a minimum, 12 indicators (exchange

rates, international reserves, central bank balance sheets, reserve money, broad money, interest rates, consumer prices, external trade, the external current account balance, external debt/debt service, the fiscal balance, and GDP/GNP (*IMF Survey*, 25 October 1995, p 315).

The IMF has also developed a set of standards to guide members in publishing economic and financial data – on a voluntary basis – to keep markets better informed. (The data categories include, in addition to the 12 cited above, industrial production, unemployment, wages or earnings, producer or wholesale prices, and domestic credit.) There is to be a general standard for all members and a more demanding special standard for members having, or seeking, access to capital markets (IMF, 1996).

These efforts at increased information provision are to be welcomed. But the idea that such a range of indicators can be turned into an effective IMF ‘Early Warning System’ is not persuasive. As we argued above (Sec. 5.7), from the perspective of the country policy-makers, the connection between outcomes on this very large number of indicators and the possible emergence of crisis is not a precise connection, and will inevitably depend on a number of difficult-to-measure factors not on this list, including policy-makers’ perceived resolve and commitment. It is therefore highly unlikely that a ‘warning system’ could be developed based on such factors. There is a parallel here with the generally unsuccessful attempts to model sovereign default risk in the 1970s and 1980s. There is no substitute for judgement on these issues. Moreover, the entire history of debt crises in many countries and varied circumstances supports Kenen’s (1996) sceptical remark: ‘It is particularly hard to believe that more timely data will cause markets to exert gradual but growing pressure on a recalcitrant government.’

### 7.2.2 The role of the IMF in crisis prevention: leverage through advice and assistance

The IMF invests a large amount of resources in monitoring and surveillance. In the wake of the

Mexico crisis, this effort has been refined to pay greater attention to countries at risk and to countries where financial tensions are most likely to have spillover effects.

There have been pressures on the Fund to make public more of the confidential assessments of countries’ positions which emerge from this process of enhanced surveillance. We believe that these pressures are misplaced.

The IMF is the leading international institution for macroeconomic research, and it should be the place from which countries can get the best quality advice on and assistance with macroeconomic adjustment policies. Provision of advice and assistance to individual countries is a legitimate role for a world-wide international institution, because of the economies of scale and scope in the provision of such analysis. This role needs to be sustained, partly because this analysis is an international public good, partly because private markets will not provide the required analysis in each individual country (where it has the character of a national public good), and finally because many national governments of poorer countries cannot afford or cannot get access to the necessary resources themselves (so that the advice and assistance becomes a form of ‘technical assistance’).

Fund advice, to be useful, must frankly stress both weaknesses and required remedies; and Fund assistance must consist in working with a country to help it solve its problems. This involves not merely one-off advice, but continuing policy assistance, and can – if crisis breaks out – involve IMF lending. It is this twin feature – frank diagnosis by the IMF followed by continuing work together to solve the problems identified – which makes the advice and assistance relationship between the IMF and its client countries a particular one. Current problems are clearly identified and a commitment established to solve them through future work. This is a relationship of trust, as well as of the power that comes from the conditionality of IMF lending.

If the IMF were to divulge more of its confidential assessments of countries’ positions to the

markets, it is hard to see how this relationship of trust could survive. Current problems, clearly identified, are facts which the market can readily appreciate; a commitment to solve them through future work is much more difficult to evaluate. It therefore seems inevitable that release of confidential reports to the markets would do more harm than good. As a consequence the relationship of trust between the Fund and its clients would inevitably be broken, in two ways. First, the advice from the IMF would necessarily become more formal, and cautious in its criticism (cf. OECD country reports), and the information which countries provide to the Fund on which this advice was based would itself become less frank. Second, the Fund's relationship with the country would necessarily become more hands-off, since working with a country to solve its problems and releasing critical information to the markets about its difficulties point in opposite directions. It is as if management consultants called by a company to advise management on strategy and assist with its implementation were compelled to make known the contents of their report to shareholders.

In short, the IMF is not a ratings agency, nor should it aim to become one. It should continue to provide confidential advice to countries and to work with them, confidentially, to solve their problems. Private market participants would naturally like the Fund to do part of their work for them, and to have another party to blame should their analysis prove inadequate – but these pressures should be resisted.

### 7.2.3 The role of the BIS in crisis prevention and the role for regional central bank co-operation

The issues discussed above are obviously ones in which increased central bank cooperation would be useful. The Bank for International Settlements is a forum for such cooperation. Its members ('shareholders') are exclusively central banks, and it has become the principal forum for discussion, consultation and cooperation among central bankers in western countries. Two of its

main functions are information and experience sharing, and banking supervision and surveillance. The Bank for International Settlements has an important role to play in advice and assistance with the surveillance and supervision of domestic financial markets. Most of the proposals for the big changes in bank supervision which have happened in the past 20 years have come from the BIS Committee on Banking Supervision, including the capital adequacy requirements in relation to credit risk and market risk. The BIS can also play a parallel role to the IMF in relation to the informal sharing and dissemination of advice among central bankers about appropriate macroeconomic policies, including policies in the face of capital inflow, but currently its role in this regard is relatively limited.

It may be that these issues can also be tackled by regional central bank cooperation. In a recent speech, Bernie Fraser (1995), the Governor of the Reserve Bank of Australia, has called for the creation of an institution modelled on the BIS and serving central banks in the Asia Pacific Region. The proposed membership of this grouping is: Australia, China (PRC), Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand, based on the current membership of the Executive Meeting of East Asia and Pacific Central Banks. Fraser notes that current international institutional arrangements are not ideal from an Asian perspective. Appropriate regulatory frameworks will differ depending upon economic structure, yet those who decide upon BIS rules are entirely from the G10, which means that, apart from Japan, Asian regional perspectives have no influence. Furthermore there are certain concessions in the BIS risk weights which discriminate against banks from non-OECD countries in ways which might be thought to be unfair.

### 7.2.4 Tobin Tax

Nearly 20 years ago Tobin (1978) suggested some preventive medicine for international financial crises – a tax that would throw sand in the wheels

of international capital flows. The idea was that the existence of, or the potential for, destabilising speculation constitutes a market failure which could be responded to in the “normal” way by some price-mechanism signal – a tax.

Ever since the original Tobin paper there have been a number of observers who have believed that the imposition of such a “Tobin tax” would be a highly desirable reform of the international monetary system. In the context of our report, this proposal has a number of serious problems. (For a detailed and balanced discussion readers are referred to Haq, Kaul and Grunberg, 1996, where the proposal has been reviewed in detail).

The proposal is for a low rate of tax of 0.05 per cent of the value of transactions (see Kenen in Haq *et al.*, who argues for a low tax to discourage substitution and migration). A tax at this rate would perhaps raise as much as \$100 billion if it did not lead to changes in volume.

Such a tax would make very little difference to long-term transactions. This is because it is within the range of existing spreads and/or transactions costs. Nevertheless, there is no doubt that such a tax would decrease the amount of short-term trading. If the horizon were as short as one day ‘as it is for most traders’ (Frankel, p 13, in Haq *et al.*) then the relevant calculation relates to switching in and out 240 times a year, on which the repeated payments of the tax would amount to an annual rate of tax payment of 24 per cent (=  $240 \times 2 \times 0.05$  per cent).

Such a tax could not be levied in an individual country but would have to be levied in at least the major half dozen large trading centres in the world. An arrangement is suggested whereby the tax would be levied in two halves, half at the country of source of the trade and half at the country of destination, and if either of these were in a tax-free offshore haven then the other half would be paid at a higher or even a penalty rate. Nevertheless a high degree of international political cooperation would be required in order to make levying the tax politically viable. This in turn would surely require agreement about its effectiveness, and that agreement is not present.

The three major problems with this proposal are as follows.

First and most seriously, it appears that such a tax would need to cover a wide range of transactions, not just spot foreign exchange transactions. Any attempt to make the tax just applicable to spot currency transactions would lead to substitution of spot trades with tax-exempt futures trades. Any attempt to tax those would lead to their replacement by tax-exempt option trades. Any attempt to tax them would lead to their replacement by more yet more complex tax-exempt derivative trades. All such futures, options, swap and derivative trades could be automated to replace the desired spot trade, so the transactions costs of avoidance would be very low indeed. (The case is very different from that of other tax bases where organising avoidance across the line of exemption is very costly – for example, avoiding a housing sale tax which has an exemption for sales of the matrimonial home is possible but involves complex adjustments of lifestyle.) There is the spectre here of a long and complex line of required ‘followup taxes’ which appear to make this whole prospect a non-starter, unless the rate of tax were so extremely small as to make avoidance in the way described not worthwhile. It is not at all clear that a rate as low as 0.05 per cent satisfies this requirement.

Second, as Frankel (in Haq *et al.*) points out, the imposition of such a tax might change the whole foreign exchange industry in unexpected and possibly undesirable ways. At present it is a highly competitive industry, with a myriad of dealers playing the central role. These dealers lay off the risk of uncovered positions among each other in a complex way. Whenever any trader incurs the risk of an uncovered position incurred when a ‘primary client’ outside the market buys foreign exchange, that trader lays off the risk by passing it around other dealers like a ‘hot potato’, rather than by conducting an auction to find that other one dealer who wishes to take the risk. This means that any primary trade sets off a ripple of secondary trades, and

partly (and perhaps significantly) explains why such a high proportion of foreign exchange trades are trades 'within the market'. The foreign exchange market thus works to an important extent like a re-insurance market. (Why it does so appears not to be entirely well understood.) A transactions tax, at a rate large enough to make a difference, would very likely lead to a change in this market structure, with the emergence of large traders who would bear the risks of individual 'primary' trades in-house. Such large traders would have scale advantages – larger size would allow risk spreading without the need for transactions external to the firm- and this might be enough to tip the whole industry away from its present competitive structure to a monopolistic one. For all its faults, the present industry may be preferable to one in which currency values were influenced, and perhaps controlled, by a few global brokerage houses. Again, this consideration points to the fact that any tax would have to be at an extremely low rate in order to avoid the risk of this disturbance to market structure. Because there appear to be so many links in the hot-potato chain, it is again not clear that a rate of tax as low as 0.05 per cent would satisfy this requirement.

Finally, and most importantly for our purposes, a Tobin tax seems unlikely to yield sufficient of the advantages which it is supposed to possess in respect of international monetary reform. It may be that a tax of this kind could discourage merely speculative investments and so lower very short-term volatility in international capital markets. (See Frankel, *op cit.*). But it is not volatility which was our concern in this report, but domestic monetary autonomy and vulnerability to exchange rate (more generally, financial) crisis. Given the constraints, the Tobin tax cannot address these two issues. If the rate of tax really were low – as low as 0.05 per cent – then that would be such as to yield an extra freedom of interest rate policy that was unmeasurably small. The trilogy of fixed exchange rates, international capital mobility, and domestic autonomy would still be unattainable. Equally

important, a tax at this low rate would be of no assistance in stemming speculative outflow against a currency which was thought to be overvalued. As a currency crisis looms the prospective capital gains and losses are *more than two orders of magnitude* larger than this tax rate. As Eichengreen and Wyplosz point out (in Haq *et al.*), such a tax might marginally slow down the onslaught of a crisis, by discouraging the initial flows before the onset of the crisis became apparent. But it is hard to see how it could do more than this.

Thus we conclude that the case for the Tobin tax is unproven. It may have to be at an extremely small rate to avoid evasion and to avoid causing undesirable concentration in the market structure of foreign exchange trading. But at such a small rate it seems unlikely to achieve its aims.

### 7.3 Crisis Management

There are two sorts of crises which a country may encounter – liquidity crises and solvency crises. We discuss the first of these – liquidity crises – in the remainder of this Chapter, and devote the whole of the next chapter to the second problem of solvency crises.

#### 7.3.1 Illiquidity

Consider the following three sorts of problems:

- ❖ A country with macroeconomic policies which are fundamentally sound may nevertheless find itself faced with very short-term external pressures. These may stem from events largely outside its direct control, but which seem likely to reverse or to dissipate relatively quickly, without major changes in underlying policies.
- ❖ A country may also face pressures which are to some extent the result of policy actions which it has taken (or failed to take), but the country may have subsequently taken corrective measures that could be expected to resolve the problem relatively quickly (or may be about to take such measures).

- ❖ A country in which there are thought to be problems of either of these first two kinds – even if objectively there are not – may nevertheless face speculative withdrawal pressure – i.e. a kind of national ‘bank-run’.

Funds which enable a country to borrow in such circumstances are intended to be merely ‘liquidity support’ or ‘lender of last resort’ money. They do not address any need for financial restructuring, to which we turn in the next section.

### 7.3.2 The role of the IMF

Lending for such purposes is regularly part of IMF adjustment programmes for countries which run into macroeconomic difficulty. There are deep questions as to whether, with the globalisation of international capital markets studied in this report, such liquidity lending from the IMF is needed. It might be thought that, as emerging market economies engage in financial market liberalisation, there is no longer need for such lending. When the Fund was initially set up, and there was very limited international mobility of capital, there was an obvious need for the Fund to supervise the creation of international reserves which countries could use for adjustment finance, and to itself provide additional liquidity to countries to tide them over adjustment episodes. The question addressed here is whether there is another different argument for such a role in a world of high capital mobility.

Both experience and analysis suggest that such lending is necessary. At a time of crisis, when macroeconomic adjustment is needed, private lenders may be unwilling to do what they perceive as ‘throwing good money after bad’. That is to say, the private sector may be unwilling to commit funds even if the need for financing is as limited as that described above and even if it will be no more than temporary.

The IMF will be able to do things that are not possible for private sector lenders in such circumstances. It will be able to invest enough resources in monitoring conditions in the bor-

rowing country to determine that the need for lending is indeed temporary. A private ratings agency could not do this, for two reasons. The first is the classic public good problem concerning the underprovision of knowledge: once the rating is publicly available its sale value disappears. The second is that such a private body may see it as no part of its task to advise clients to lend to countries that are in present difficulty but are expected to be in good shape in the future. To cope with such problems it might be conceded that such an agency should be an international institution (i.e. non-private). But with such a body there might be irresistible ‘grade creep’ pressure on it to improve its ratings.

Moreover, the Fund is able to impose its conditionality on borrowers. In the absence of such conditionality private creditors might fear that a borrower – even in the relatively benign circumstances referred to above – would use a loan merely to continue to run a deficit, rather than employ it as temporary financing while embarking upon the changes which are required for adjustment – changes which in due course would enable the money to be repaid. Such fears might prevail, even although the borrowing government was in fact committed to adjustment, because no firm and credible (‘bankable’) commitments could be given that the funds would in fact be used for adjustment in this way. Thus the outcome of relying on private creditors at a time of liquidity crisis, even if serious adjustment efforts are begun, may be no loan at all.

The ability to attach conditionality to adjustment funding is therefore central to the IMF’s ability to provide such funding, in a way in which private markets cannot. The Fund’s ability to impose such conditionality arises fundamentally from its legitimacy as a multilateral Bretton Woods Institution. There have been few attempts to apply such conditionality by private financial markets and no known example of private markets doing this effectively. The Peruvian government in 1976 allowed a consortium of US banks to impose conditions on it, and to monitor their implementation, in return

for a \$240 million loan. The conditions were not met, the stabilisation was a failure, and the IMF was called in the following year (see discussion in Rodrik, 1995a).

Nevertheless it is important to find the right balance between Fund lending and market lending in obtaining adjustment finance, and to ensure that such adjustment finance is sufficiently speedily arranged. The Mexico episode raised serious questions on this score. These have been dealt with in ways now to be described.

### 7.3.3 Short-term Emergency Financing Facility (EFM), General Agreements to Borrow (GAB), and Quota Increases

The history of a proposal to provide short-term emergency financing goes back to the responses to the European Monetary System (EMS) crisis of 1992/3, when consideration was given to a short-term facility, particularly for emerging markets. Countries, it was envisaged, could be pre-approved for this facility and could then draw down from it. These ideas were discussed by the Executive Board of the IMF in early 1994, but without reaching agreement. The problem is that the Fund would only be prepared to provide support in the amounts required if it was judged that underlying policies were sound. Such judgements are continually changing over time and take time to revise. The Mexican difficulties turned out to need much larger sums of money than those which had been envisaged in earlier discussions. In the end, the response was entirely ad hoc. Very great speed was required, with disturbing implications for any future formal procedure. The Halifax summit in June of 1995 led to a further set of proposals to regularise the official response.

As a result of this history, there are now in place within the Fund agreed procedures on how to handle countries in these circumstances. (These were agreed by the Executive Board prior to the October 1995 Annual Meetings and agreed by the Interim Committee at that time. See *IMF Survey*, 23 October 1995, p 315) These introduce an Emergency Financing Mechanism, or procedure, to enable the IMF to respond rapidly – with size-

able front-end loading where necessary – to deal with potential Mexico-style crises. The use of such procedures will not necessarily involve exceptional financing (exceeding IMF access limits) and will be subject to strong conditionality. Such procedures are not, and cannot be, fully prescriptive, and are best thought of as a kind of fire alarm drill. But they make it likely that the kind of support money necessary could be organised and issued within two or three weeks. For their effective operation, such procedures will require very close working relationships between officials in the Fund and in the country concerned.

The significance of these new procedures is hard to quantify, for they have not yet been tested by a major crisis. It is however notable that these arrangements were put in place at the same time as plans were announced to expand the General Agreements to Borrow (see *IMF Survey*, 23 October 1995, p 319). Only the G10 countries participate in the GAB, but the IMF may call upon it to assist a non-participant in a crisis that 'could threaten the stability of the international monetary system.' The new arrangement will double the existing credit lines, to \$49 billion, and bring in new participants, but the G10 will still have a major say in approving use of the funds. It is also not clear that this will be much help to any but the largest developing countries, since the use of funds would be limited to cases which are judged to pose systemic threats.

There is also now a significant move afoot to double the IMF's quotas. 'Taking into account the massively increased scale of international financial flows, taking into account the need for the Fund to be credibly equipped to help countries likely to need our financial support while dismantling their remaining exchange controls, and taking into account the fact that this quota review will determine the Fund's resource base into the early years of the next century... my judgement is that a doubling of quotas is needed.' (M. Camdessus, *IMF Survey*, 23 October 1995, p 319). It seems essential that these initiatives succeed in order to provide the necessary liquidity for the IMF to successfully carry through the use of the EFM

as and when it is needed, and in order that it be seen to have sufficient resources to do so – also a confidence-enhancing perception.

#### 7.3.4 The role of the BIS and of regional central bank cooperation

Liquidity financing is an issue on which increased central bank cooperation would be useful. The Bank for International Settlements is already a forum for such cooperation and has occasionally provided short-term support (e.g. to Hungary in 1982).

Providing such emergency assistance in exceptional circumstances is something which could also be done at regional levels. The development of contingency planning and response capability for these purposes in the Asia Pacific Region has been suggested by Fraser (1995). Responses could range for example from information sharing through coordinated foreign exchange operations, and foreign exchange

swap agreements, to more highly structured temporary credit facilities. (p. 25)' Fraser notes the developments at the IMF reviewed above and argues that 'assistance from an institution as large as the IMF (it has the interests of 179 members to reconcile) might not be available as quickly as it is required. [T]here is still a case, in my view, for close neighbours to have their own mutual support arrangements to deal quickly with emergency situations. (p. 24)' Recent press reports (*Australian Financial Review*, April 26 1996) suggest that some progress has been made in this direction. But private sources indicate that the agreement so far is very limited indeed (apparently it simply concerns Repurchase Agreements, involving a short run transfer from one side of a bank's balance sheet to another, without exposure to market risk, of a kind which is common in open market operations and debt management).