

PROTECTING AGAINST  
**VOLATILE CAPITAL  
FLOWS**



# **PROTECTING AGAINST VOLATILE CAPITAL FLOWS**

A Report of the Commonwealth Expert Group on  
protecting countries against the destabilising effects  
of volatile capital flows



Commonwealth Secretariat

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Published by the Commonwealth Secretariat  
Designed by Joanne Summerfield  
Printed in the United Kingdom by Lanes Printers, United Kingdom  
Wherever possible, the Commonwealth Secretariat uses paper sourced from sustainable forests or from sources that minimise a destructive impact on the environment.

Copies of this publication can be ordered direct from:  
Vale Packaging Ltd, 420 Vale Road, Tonbridge,  
Kent TN9 1TD, United Kingdom  
Tel: + 44 (0)1732 359387  
Fax: +44 (0) 1732 770620  
E-mail: [vale@vale-ltd.co.uk](mailto:vale@vale-ltd.co.uk)

ISBN: 0-85092-578-9

Web site: <http://www.thecommonwealth.org>

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## Foreword by the Commonwealth Secretary-General

When Commonwealth Finance Ministers met in Canada in September last year, the world economy was in the throes of possibly its worst ever crisis since the Great Depression of the 1930s. In their Ottawa Statement on the Global Economic Crisis, they therefore agreed that the international community should respond swiftly to preserve the stability of the international economic and financial system and protect the hard-won gains of economic liberalisation in many parts of the developing world. Ministers made several specific proposals for crisis prevention and management. In particular, they stressed that the present international monetary and financial system needs to be reformed and that the development of a new international financial architecture should be pursued vigorously. They proposed that reforms of the global monetary and financial system be agreed by the year 2000 at a global meeting involving broad-based representation from industrial, emerging and other countries at different stages of development.

The Commonwealth Finance Ministers based their discussions on the Report by a Commonwealth Expert Group, which I constituted in response to their request in September 1997, for a study on the lessons to be learned from the East Asian crisis and on how countries could be protected from the destabilising effects of market volatility, including those resulting from speculative activities. The Group, which brought together eminent economic and financial experts from all regions of the Commonwealth, and was chaired by Mr Chris Liebenberg, former Finance Minister of South Africa, completed a challenging task in a remarkably short period of time, holding two meetings in London in June and August 1998.

In drawing lessons from its analysis of the East Asian crisis, the Expert Group came to the conclusion that a comprehensive strategy for dealing with financial crises needs to be directed at four levels: national action to reduce the likelihood of future crises; regional actions to limit damage and contagion in the immediate neighbourhood; international actions to co-operate effectively in preventing and/or managing future crises; and strengthening international regulatory frameworks in order to enhance global stability.

The Group's recommendations for effective crisis prevention include increasing transparency of market operations; strengthening surveillance and peer reviews; regulating and/or taxing capital inflows

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and outflows; and the use of counter-cyclical policies. While the Group prefers the use of market-based measures to regulate capital inflows, it believes that it may be necessary for countries to consider capital controls, on a temporary basis, in the event of a serious crisis where the costs of any resulting distortions are likely to be lower than the alternative of an economic slump. On crisis management and containment, several proposals are made to improve the effectiveness of international financial institutions (IFIs). In particular, the Group recommends that the scale of their existing facilities and resources should be enlarged significantly, and that appropriate conditionality needs to be designed in stabilisation programmes in order to restore stability and market confidence without damaging growth in the countries affected.

The Report makes a strong case for orderly debt workout procedures with private creditors being required to continue to lend in crisis situations. This together with temporary suspension of payments would bring about the rapid resolution of crises, while reducing the scale of official financing required. The Report emphasises the need for concessional assistance for low-income countries which are hit by rapid reversals of capital flows and lack alternative sources of funding in crisis circumstances. It also stresses the importance of the World Bank, other IFIs and bilateral donors acting early and on a sufficient scale to help affected countries deal with the social implications of financial crises. Finally, the Report addresses the need to fill regulatory gaps in the international system particularly in relation to short-term bank loans and easily reversible short-term portfolio flows. It also draws attention to the potential role of regional arrangements and mechanisms in crisis prevention and management, which can play an important "mezzanine" role between national and international institutions. This is an area which has not received adequate recognition in most current proposals and therefore reflects a serious gap in the international financial system.

Since the Expert Group completed its work, developments in financial markets – especially the most recent crisis in Brazil – have underscored the importance and relevance of its key conclusions and recommendations. I hope this Report will be widely read and believe it will make an important contribution in influencing both debate and action to build the new financial architecture which the global economy needs so urgently as we enter a new millennium.

Emeka Anyaoku

## INTRODUCTION

- i. At their meeting in Mauritius in September 1997, Commonwealth Finance Ministers called upon the Secretary-General to convene an Expert Group to draw lessons from the East Asian experience and to recommend measures to protect countries from the destabilising effects of volatile capital flows, including those fuelled by speculation. This request was endorsed by Commonwealth Heads of Government at their 1997 meeting in Edinburgh.
- ii. Our Expert Group, which was constituted by the Secretary-General, met in London 15-17 June and 27-28 August 1998, under the Chairmanship of Mr Chris Liebenberg, the former Finance Minister of South Africa and currently Chairman of Nedcor Ltd (South Africa). The other experts were Dr Zeti Akhtar Aziz, Deputy Governor, Bank Negara (Malaysia); Mr Kofi Bucknor, Managing Director of CAL Merchant Bank (Ghana); Professor John Loxley of the University of Manitoba (Canada); Mr Percy Mistry, Chairman of Oxford International Associates (Britain); H E Mr J Y Pillay, High Commissioner for the Republic of Singapore to Britain (Singapore); Professor Richard Portes, President of the Centre for Economic Policy Research (Britain); Dr C Rangarajan, former Governor of the Reserve Bank of India and currently Governor of Andhra Pradesh State (India); Mr K Dwight Venner, Governor of the Eastern Caribbean Central Bank (St. Lucia); and Professor Robert Wade of Brown University (New Zealand/USA).
- iii. We also benefited from the valuable contribution of a number of resource persons and representatives of international financial institutions who participated in the discussions, namely: Mr Jack Boorman, Director, Policy Development and Review Department of the International Monetary Fund (IMF); Ms Joanne Salop, Director, Operations, Policy and Strategy and Mr Stijn Claessens, Principal Economist, Financial Sector Policy, of the World Bank; Mr Renato Filosa, Manager in the Monetary and Economic Department of the Bank for International Settlements (BIS); Mr Barry Herman, Chief of the International Economic Relations Branch of the UN; Mr Avinash Persaud, Vice-President and Head of Currency Research, J P Morgan; and Mr Brian Turner, Treasury Director, Henderson Investors. The Conclusions and Recommendations and contents of the Group's Report, however, reflect the views of the Expert Group and not necessarily those of the resource persons and representatives.
- iv. Dr Stephany Griffith-Jones of the Institute of Development Studies, University of Sussex, acted as Consultant and prepared the main report which formed the basis for the discussions of the Expert Group.
- v. We reviewed the causes of the East Asian crisis and key lessons, to be drawn from it for future policies. We also took up a number of specific issues that included an examination of the need for:

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- better information on private capital flows including the development and strengthening of early warning signals;
- strengthening domestic financial systems and the role of surveillance;
- internationally agreed standards to monitor and regulate the behaviour of short-term capital flows, as well as measures that governments can take to stabilise exchange rates, fiscal positions and levels of investment and preserve market confidence;
- defining the conditions for capital account liberalisation and the feasibility of Chilean-type measures to influence the composition of capital flows;
- consideration of the usefulness and desirability of temporary controls on capital outflows and more comprehensive exchange controls in times of emergencies;
- greater involvement of private lenders and investors in crisis resolution through the establishment of orderly debt workout procedures, including the enforcement of standstills or temporary payment suspension in exceptional cases;
- encouraging the International Financial Institutions (IMF, the World Bank and BIS) to play a larger and more effective role in the prevention, management and resolution of financial crises, with appropriate conditionality that takes account of the nature of each crisis and the social impact of adjustment;
- creating social safety nets, with the World Bank playing a more active and supportive role in the early stages of a crisis; and
- intensifying efforts to develop a new architecture for the international monetary and financial system and strengthening regional measures, including the establishment of regional funds to complement global arrangements.

vi. The Conclusions and Recommendations which we have endorsed are summarised below for the consideration of Commonwealth Finance Ministers. The Annex contains the detailed Report which served as the basis for the Group's discussions.



Chris Liebenberg



Zeti Akhtar Aziz



Kofi Bucknor



John Loxley



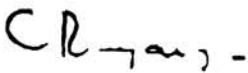
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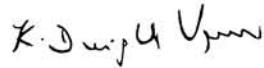
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## CONCLUSIONS AND RECOMMENDATIONS

A year after the East Asian crisis started, its financial and economic consequences have not yet been contained. The crisis has spread to other emerging economies in different regions of the world. Increasingly, it has also been transformed in the affected countries into a serious crisis in the real economy with substantial downward adjustments in output, income and asset values resulting in heavy socioeconomic damage which has disconcerting implications for political stability. A number of affected countries (such as Indonesia) will lose a significant part of their previous growth gains, with long-term structural damage to their economic and social systems resulting from the successive shocks.

As in the case of earlier crises, divergent views have surfaced on the causes of the East Asian crisis. One school of thought emphasises the failure of national policies and governments, while another points to the failure of markets as the main cause. The truth, as usual, lies somewhere in between. The lessons to be drawn from the crisis depend to a large extent on the causes of the crisis. Most explanations of the East Asian crisis tend to begin with a long list of the perceived problems of the East Asian countries. This approach can lead to the fallacy of erroneous connection, with any problem that existed prior to the onset of the crisis being seen automatically as its cause. Some of these explanations are inconsistent with the facts while others are too partial or insufficiently convincing to explain the onset or the depth of the crisis. To be convincing, the causal explanations provided must be consistent with the past record of the region. They must clearly identify those specific factors that brought about so dramatic a change, from rapid growth to deep crisis. The explanations provided must also satisfactorily distinguish between those factors that triggered the crisis and those that made it spread across the region through contagion.

The causes of the East Asian crisis are several and complex, domestic and external. However, there are three key elements which distinguish the present crisis from other recent financial crises: (a) the roots of external imbalances in East Asia were grounded largely in a rapid build-up of unhedged, short-term, private sector debt which carried large term transformation as well as exchange risks; (b) the crisis was a consequence of "over-investment" rather than "over-consumption" on the part of either the public or private sectors; and (c) it was triggered primarily by sudden capital flow reversals by global commercial banks resulting in a sharp deterioration in confidence throughout the region and

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outside it as a result of contagion. The most surprising aspect of the crisis was that it affected countries with a long track record of good macroeconomic management that had been remarkably successful over extended periods, in terms of economic growth, dynamism of their export sectors, low rates of inflation and high saving rates.

What went wrong? Clearly, there were a number of emerging structural deficiencies and policy failures in the countries themselves: a “bubble effect” in domestic financial systems; very rapid growth (and inadequate monitoring) of short-term commercial bank debt; an inconsistent exchange rate and monetary policies which induced the inflow of speculative funds; premature and ill-conceived capital account liberalisation in some instances; and the progressive appreciation of real effective exchange rates between 1995-1997 when the US dollar appreciated sharply vis-à-vis the Japanese yen, causing deterioration in the competitiveness of many of these economies. There was, however, another crucial factor which has not received sufficient attention and which affected the speed of contagion and financial market collapse across Asia: i.e. the role played by the “herd behaviour” of internationally mobile capital flows in triggering the crisis. The crisis was also aggravated by the way it was managed by international agencies who dealt with it as if it was a crisis of domestic policy failure, rather than a crisis also reflecting capital market failure and the inadequacy of risk assessments by international lenders and investors.

### Six main lessons can be drawn from our analysis of the crisis

- a) the East Asian crisis was essentially a short-term liquidity crisis when it started; but the way it was managed resulted in its becoming a crisis of solvency, political stability and long-term development;
- b) the benefits of capital flows can be considerable in stable market conditions but in unstable and irrational markets, they can become highly damaging, requiring skillful management and a degree of policy flexibility in dealing with capital surges and reversals;
- c) there are serious risks in relying excessively on foreign capital to finance investment, especially when domestic savings are high; more attention needs to be given to improving the quality of investment, which will also help to reduce over-dependence on foreign capital;
- d) whatever adjustment measures are taken to contain the crisis and accelerate recovery, affected governments must give priority to restoring

- stability and confidence and to ensuring that the social impact of the crisis is minimised;
- e) priority should be given to crisis prevention and containment measures because of the high economic, social and political costs of financial crises and the speed with which they can spread through contagion and become a worldwide debacle; and
  - f) since markets react sharply and swiftly to perceived weaknesses in economic fundamentals, it is of critical importance that responses to financial crises be swift, unambiguous and substantial; it also means that in the absence of a lender-of-last-resort, priority needs to be given to negotiating orderly debt workouts with private creditors at an early stage to ensure a more efficient outcome.

These considerations suggest that a comprehensive strategy for dealing with financial crises needs to be directed at four levels: national actions to reduce the likelihood of future crises; regional actions to limit damage in the immediate neighbourhood; international actions to co-operate effectively in preventing and/or managing future crises when and if they happen; and, finally, strengthening international regulatory frameworks in order to enhance global stability.

### Crisis Prevention

As crises are costly and spill over swiftly into other countries, high priority needs to be given to crisis prevention measures. A number of proposals to reduce the probability of future crises are currently being discussed in different international fora. The three main ones are: improving the availability (and transparency) of economic information and policies to both the IMF and the financial markets; strengthening domestic and international surveillance; strengthening domestic financial systems, by improving regulation and supervision; and encouraging more orderly and properly sequenced liberalisation of capital accounts. The Group believes that while these proposals represent necessary steps towards a stronger international financial system, they are not sufficient to prevent future crises. Strengthened surveillance by itself is only a partial and weak remedy. Defences at national, regional and global levels also need to be strengthened to contain and reverse crises swiftly instead of letting them get out of hand, as happened in Asia in 1997 and is now happening in some other parts of the world. Better mechanisms are needed to cope with market over-reaction and to implement far-reaching financial sector

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reforms in emerging markets. Similarly, early warning indicators can often be unreliable and can lag behind an unstable dynamic process. Thus, by the time available indicators are visibly out of line, it is usually too late to attempt to prevent a crisis.

With each successive crisis it has become clear that the signals and indicators being looked at were not necessarily the right ones. The East Asian crisis has made it clear that market signals are as important to track as macroeconomic indicators. Recent developments have also highlighted the problems that can occur when fragile emerging market economies open their capital accounts prematurely. While capital account liberalisation should remain an ultimate goal, the approach to such liberalisation should be cautious. Liberalisation should be introduced in phases and move in tandem with the strengthening of the domestic financial system. It also follows that (in the event of an amendment to the IMF Article relating to capital account issues) countries opening their capital account should have the necessary flexibility to reverse liberalisation measures, temporarily, if changes in the macroeconomic or political conditions, at home or abroad, call for it.

All these considerations suggest that an effective crisis prevention and/or management strategy will require the use of sharper and a more comprehensive array of tools at the national, regional and international levels than have been proposed so far.

## Increasing the Transparency of Market Operations

The focus of the current call for improved transparency and surveillance has been at the recipient country level. It is equally important that the same precepts apply to market participants. In particular, greater attention needs to be given to the risks posed by potential large reversals of capital flows and, in particular, the role played by financial markets, especially the roles of currency traders and hedge funds, in influencing currency and asset price movements in thin and imperfect markets which are particularly vulnerable to attack. The possibility of extending large trade and position reporting systems (now practised in the futures trade) to cover currency trading and hedge fund activity should be examined as a matter of urgency. Just as timely and accurate information on the macroeconomic and financial situation of a country is necessary to facilitate decision-making in financial markets, a more transparent market structure and operation would enable governments in both recipient and source countries to implement effective market-responsive regulations and policies. For better

monitoring and understanding of markets, government regulators and international institutions should build on the current practice of increased dialogue with traders and private financial institutions.

### **Strengthening Surveillance and Peer Reviews**

There is also a need to better co-ordinate surveillance of domestic financial systems in all countries. Recent events have clearly demonstrated that domestic financial sector problems can spread regionally or internationally. It is, therefore, in the interest of all countries that proactive steps are taken to ensure stability at national, regional and international levels. In this context, the Canadian proposal called the "International Supervisory and Surveillance Initiative" is of particular interest and needs to be considered seriously. It calls for the establishment of new international arrangements to improve supervision and regulation of domestic financial systems and to identify financial sector problems before they become international crises. The proposed arrangement would also involve close collaboration with the Bretton Woods institutions and the BIS, and would bridge the roles that surveillance, peer pressure and support can play in encouraging countries to build strong financial systems according to international standards.

### **Regulating and/or Taxing Capital Inflows and Outflows**

There is a strong case for capital-receiving countries themselves to discourage sustained surges of short-term capital flows. In particular, they should be wary of short-term foreign currency borrowing by banks and corporates and consider using market-based discouragements such as taxes or non-remunerated reserves (involving interest-free deposits with central banks). Such measures have been used successfully by Chile and Columbia to: increase the share of foreign direct investment and long-term loans within total capital flows and decrease the share of short-term and potentially reversible flows; increase the autonomy of domestic monetary policy and drive a wedge between domestic and international interest rates; and to curb large over-valuation of the exchange rate, caused by a surge of capital inflows, which discourages exports and poses the risk of growing and unsustainable current account deficits. Two of the attractive features of the Chilean-type measures are that they are market-based rather than quantitative, and they apply to all short-term flows, thus simplifying administrative procedures and reducing possibilities of evasion. These measures have

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not always been uncontroversial; they need to be designed with particular care to avert the prospect of their deterring capital flows altogether.

It is encouraging to note that major financial institutions now explicitly recognise that – despite some limitation and microeconomic disadvantages – market-based measures taken by recipient governments to deal with surges of short-term capital flows can play a positive role, if they are part of a package of policy measures that include the establishment of sound macroeconomic fundamentals as well as strong and well-regulated domestic, financial systems. International institutions should undertake further work on the feasibility of such measures and assist governments in emerging markets to design appropriate instruments and contingency measures which could be suitably applied at times when countries are receiving excessive inflows of short-term capital and when other key conditions are in place. While the use of market-based measures to regulate capital inflows are to be preferred, it may be necessary for countries to consider a careful application of capital controls of an administrative character or exchange controls, on a temporary basis, in the event of a crisis as serious as in East Asia. Such controls would seem to be justified in exceptional cases where the costs of any resulting distortions are likely to be lower than the alternative of an economic slump which progressively worsens.

In addition to using regulations and controls, capital-receiving countries could also explore other market-based instruments to discourage currency traders from taking short positions on their currencies. While the market uses a myriad of derivative instruments, central banks tend to limit themselves to traditional instruments. If they were to use the opportunity of capital inflows to take advantage of financial insurance instruments, they could consider creating incentives which would have the effect of deterring market participants from speculating against the local currency in times of trouble. When large, international commercial and investment banks request banking and securities licences, governments could insist that one condition for granting such licences would be for the central bank to buy (for a modest fee) from these banks, some insurance against future currency volatility with a call option on the existing value of the dollar vis-à-vis the local currency. This would oblige the seller of the option (the international bank) to sell at a future time to the central bank a pre-agreed volume of dollars at the existing exchange rate, thus incurring the risk of a loss on its own speculation. This is a new proposal; it has not been studied thus far and requires further examination, both in terms of its practicability and its impact on the cost of capital.

## The Role of Counter-cyclical Policies

The role of counter-cyclical monetary and fiscal policies of capital-receiving countries in regulating capital inflows is also important. It is when inward surges of short-term capital occur that recipient countries have greater degrees of freedom for policy-making than when capital is flowing out. A tightening of macroeconomic policies is particularly desirable when indicators of vulnerability to a currency crisis point to rapid deterioration, or when they pass certain prudent thresholds. Thus, adequate levels of net usable foreign exchange reserves and limits on the level of short-term external liabilities are crucial for preventing currency crises. An appropriate exchange rate regime with a consistent internal interest rate regime is also important to make economies less vulnerable to currency attacks. There are often good reasons to have a pegged nominal exchange rate; but problems with a pegged rate arise when it becomes overvalued. If countries wait until a nominal peg is attacked, it will be too late to avoid a crisis by floating the currency. In such a case, countries could move much earlier to some sort of managed float, which can help avoid real appreciation. Rapid sharp increases in interest rates could also be effective in some, but not in all, cases for preventing large currency depreciations. Such increases are never effective if they have to be maintained for very long. They can be particularly counter-productive in economies which are highly leveraged, as in East Asia, and convert what may essentially be a crisis of liquidity into one of insolvency. While some increase in interest rates may be necessary to provide a signal, this should be supplemented by slowing down credit growth; the use of ceilings on lending for property; and the use of prudential regulations.

## Crisis Management and Containment

Once a country enters into a financial crisis, it usually cannot cope on its own. International assistance has to be called in to mount a rescue effort. While each situation has its own dynamics, there are a few obvious lessons that can be drawn from recent experience.

### The role of International Financial Institutions (IFIs)

The first response when a large currency crisis starts unfolding in one or more countries, is to activate a timely, large and credible injection of official liquidity to provide the important public good of stability. The best solution is to enhance the capacity of the IFIs to perform this function more effectively. Improvements need to be made first in the speed of such

lending, given the incredible speed with which markets move today. Secondly, the scale of existing facilities and the resources available to international financial institutions need to be enlarged significantly, in view of the vastly greater scale of private funds flowing through international markets. To enhance the scale of official facilities, priority needs to be given to securing an immediate increase in IMF quotas; the possibility of co-financing or standby facilities with the private sector – and particularly with private banks – also needs to be explored urgently.

Finally, the issue of appropriate conditionality attached to financial packages needs to be re-examined to ensure that in any future crises, conditionality is designed to restore stability and market confidence as quickly as possible without damaging growth in the countries affected. A number of valid criticisms have been made of IMF programmes during the East Asian crisis. It has been argued that conditionality has been too intrusive and too comprehensive, attempting to make dramatic structural changes in very short periods even before stabilisation has been achieved. Conditionality has also been inappropriate in several important respects (e.g. indiscriminate bank closures, over-adjustment through excessive tightening of fiscal policy, over-emphasis on full debt repayment involving bailing 'out' rather than bailing 'in' creditors, especially commercial banks, which engaged in imprudent short-term lending). Many observers have pointed out that some of these measures might well have added to, rather than corrected, the panic in markets which the crisis unleashed. A key challenge for IMF (and country) programmes is to design appropriate macroeconomic responses for currency crises that mainly originate in private sector imbalances and not – as traditionally Fund packages were accustomed to dealing with – public sector imbalances, reflected in fiscal or current account deficits. They should aim, first and foremost, at stabilisation and the restoration of market confidence before tackling longer term issues.

### **Bailouts, standstills and orderly debt workouts**

Because of the large scale of capital flows in the 1990s, public inflows from the IFIs can no longer be relied upon to finance private outflows during a crisis. In response to this situation, as well as to increased concern over moral hazard issues, a more efficient means of imposing creditor discipline and burden-sharing is required, with banks and investors taking more of the responsibility for the ongoing provision of loans or credits to borrowers in crisis-affected countries. Accordingly, there is an urgent need for early agreement on orderly debt workout procedures, which would bring about the rapid resolution of crises,

while reducing the scale of official financing needed. In a short-term liquidity crisis (such as in East Asia), the timely provision of significant further credit by the private sector could avoid the imposition of unnecessarily severe austerity measures on affected economies. In such cases, the official sector should focus less on permitting private creditors to exit and more on bailing them in by enforcing early debt negotiations as a precondition for its support. Indeed, the present basis of providing official finance first and then negotiating debt relief as a residual should be reversed, with the amount of official financing needed becoming the residual, after other alternatives are exhausted.

In addition, new rules of the game in international finance should require the enforcement of 'standstills', or temporary payment suspensions, to become a necessary and early part of the crisis resolution process. Consensually agreed protocols for payment suspension, as part and parcel of crisis management, need to be designed to encourage creditors to agree to rapid debt renegotiation on appropriate terms. This will also require agreement on the trigger points at which such measures can be invoked. If it becomes accepted international practice for governments to be able to impose a standstill as part of a process of co-operative and non-confrontational debt renegotiation, creditors would have no reason to penalise them; moreover, it would serve as a disincentive for irresponsible lending by commercial banks.

It is unfortunate that though orderly debt workout initiatives were endorsed by the G10 in 1996, nothing came of them by the time the Asian crisis began in the summer of 1997. It is imperative that significant progress is made in implementing such initiatives before the next one occurs. The official sector should now press for the inclusion and implementation of contract clauses in commercial bank loans, market bonds and other credit instruments to facilitate orderly restructuring of securitised and commercial debt. At the same time, the IMF should signal its approval of the process by agreeing to lend into arrears to countries whose policies and prospects are considered acceptable.

### **Concessional finance for low-income countries**

Distributional questions also need to be taken into account. The existing procedures for emergency financing are primarily invoked in crises which pose a systemic threat at the global level. However, there are a large number of smaller and poorer countries in Africa, Central America and the Pacific which have been hit by rapid reversals of capital flows as a result of contagion. They need adequate official international assistance since

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they have virtually no access to alternative sources of market funding in crisis circumstances. It is therefore important to introduce greater flexibility in access to the IMF's emergency financing mechanism, as well as to IDA resources, to assist these countries in times of crisis.

### **Dealing with the social impact of crises**

The World Bank, other IFIs and bilateral donors should act early and on a sufficient scale to help countries deal with the social implications of financial crises. Within crisis-affected countries, the immediate protection of public expenditures for social programmes, food security and safety nets is essential and the programmes agreed with the IFIs need to have adequate funding. The IFIs and bilateral donors were not sufficiently involved in addressing social impacts in the affected East Asian countries from the outset. Failure to do so resulted in social and political difficulties being magnified with further perverse effects on market confidence.

### **Crisis containment, reversal and recovery**

Crisis containment and reversal should be crucial elements of any crisis management strategy. In the short-term, one of the primary tasks in containing crises is to restore the confidence of domestic and foreign investors in the economy. This would involve influencing and changing the direction of market expectations by giving clear signals of national commitment to undertake the necessary adjustments. Long-term financial support from the IFIs is also essential for the recapitalisation and restructuring of the banking sector in order to get the domestic financial sector working again, and for tackling supply side issues, such as the provision of adequate working capital and export credit facilities which usually dry up during financial crises. It is equally important to ensure that the reform process in the crisis-affected countries is co-ordinated so that slippages in one or two countries do not hold back recovery in others.

### **Filling regulatory gaps in the international system**

Actions by recipient countries and international agencies by themselves are not enough to deal with the problem of capital surges and the risk of their reversal. It is equally important to complete and improve international prudential supervision and regulation to adapt them to the new scale and nature of private flows, and to fill existing regulatory gaps.

There are four major areas where such gaps need to be filled.

Firstly, recent experiences demonstrate that the way in which the global financial system operates is not always well understood by governments nor for that matter by the IFIs. 'Miracle economies' in one month can suddenly be denigrated as bastions of 'crony capitalism' the next. Such selective and fickle perceptions need to be corrected or avoided.

Moreover, while there is a need to ensure that regulation across financial markets which are integrating rapidly, is consistent and comprehensive, there is no reason to force all countries into the same rigid and standard regulatory mould. Instead, regulatory regimes and policy frameworks that are developed internationally should be flexible enough to accommodate different models of market economy, and financial systems, while ensuring prudence, probity and integrity.

Secondly, it is important to ensure a degree of symmetry in prudential supervision and regulation in source countries, and to adapt it to the new scale and nature of private flows. There are two categories of flows to emerging markets where additional international and/or source country regulation and supervision may be necessary: (a) short-term bank loans (particularly culpable in the 1982 debt crisis and in the 1997 Asian crisis); and (b) easily reversible short-term portfolio flows (especially important in the Mexican peso crisis) which are invested in short-term, exchange risk-proof instruments. International bank loans (including short-term ones) are already regulated by industrial countries' central banks and coordinated by the Basle Committee. However, existing regulations are clearly not sufficient to discourage excessive short-term bank lending. For example, for non-OECD countries, loans of residual maturity of up to one year have a weighting of only 20 per cent for capital adequacy purposes, while loans over one year have a weighting of 100 per cent. As a result of this rule, short-term lending is more profitable for international banks. A narrowing of this risk differential by raising the risk premium for short-term lending should therefore be pursued.

In the case of portfolio flows to emerging markets, at present there is no regulatory framework for taking account of market or credit risks on flows originating from institutional investors in developed countries, such as mutual funds (and more broadly for flows originating in non-bank financial institutions). However, this is a new and contentious topic and it is important that any regulatory proposals in this area should emanate from guidelines formulated by a working group consisting of representatives of source as well as emerging market countries, as was done in developing the Basle Core Principles. Thirdly, the East Asian crisis has highlighted the need to establish or upgrade domestic "financial safety nets" supported by internationally

agreed standards or best practice. Such safety nets would consist, inter alia, of deposit insurance schemes, lender-of-last resort policies, (i.e. policies for extending solvency support and exit policies) and prompt corrective actions, including the orderly closure of insolvent financial institutions. Properly conceived financial safety nets reduce the probability of financial crises, curtail their duration and expansion when they occur and facilitate crisis management. Internationally agreed standards represent independent benchmarks against which transparency and the accountability of national policies and practices can be compared. Despite significant progress, their development is incomplete. Current efforts need to be directed particularly at developing or improving the implementation of international standards relating to banking supervision, securities and derivatives market regulation, insurance supervision, auditing and accounting, bankruptcy, fiscal transparency and corporate governance.

In addition to filling gaps in the existing regulatory framework, various suggestions have been made recently for cross-border taxes on currency transactions to slow down speculation in currency trading. The Group believes that the problems which arise with the implementation of such proposals raise serious doubts about their efficacy. However, the degree of speculation that has taken place in the recent crisis and its serious negative consequences have raised acute concerns. It therefore seems appropriate to continue exploring how market-based disincentives might be created to discourage excessive speculation. Furthermore, in seeking solutions to East Asian-type crises, it is also important to take account of the microfactors behind position taking within global financial institutions, as well as other practices that induce high-risk trading in financial markets, especially as such practices may encourage currency speculation and exacerbate its highly negative effect on systemic stability.

Finally, further examination is required to detect and cover any other existing monitoring and/or regulatory gaps, in three major areas. The first relates to instruments such as derivatives and institutions such as hedge funds. The second concerns the need for an independent peer review of the methodology and modus operandi of credit rating agencies, whose sudden retrospective changes in country ratings can reinforce market volatility and create perverse expectations. The third concerns the need for a better understanding of recent changes in global credit and capital markets, and of the criteria used by different categories of market actors – including banks, mutual funds, hedge funds and others – to go in and out of countries as well as the incentives that explain these patterns.

## Regional Initiatives

In policy discussions on the East Asian crisis, not enough attention has been paid to the potential role of regional arrangements and mechanisms in crisis prevention and management. In coping with financial crises, there can be little doubt that regional arrangements can play an important “mezzanine” role between the national and international institutions. This would be easiest among countries with a clear regional identity. The absence of suitably designed regional arrangements (except in Europe) in the present array of institutions, facilities and instruments which exist to combat such crises, reflects a serious gap in the international financial system. Precisely what such arrangements should be, will inevitably depend on the particular characteristics, needs and circumstances of the countries in each region.

Clearly, a comprehensive set of arrangements – with matching institutional capacity – would need to encompass the following functions and capacities: i) surveillance and early warning capacity, coupled with the institutional ability to exert peer pressure in inducing essential policy changes and course corrections swiftly and effectively; ii) the capacity to avoid repeated rounds of competitive devaluations from occurring in neighbouring countries and preventing countries from adopting beggar-thy-neighbour policies to exit from a crisis likely to engulf the region; iii) sufficient intervention capacity in currency and financial markets to restore market confidence and forestall the prospect of free falls in currency or financial markets; iv) the ability to provide sufficient post-stabilisation liquidity and long-term finance in tandem with multilateral and regional development banks, to prevent disruptions to financial systems, economic growth and social stability at critical junctures in the stabilisation and adjustment processes; and v) the collective capacity to induce essential long-term structural changes in financial markets and institutions and to promote greater capacity for self-regulation and prudential behaviour on the part of private sector institutions as well as national regulatory authorities.

Such arrangements can complement to an important degree the global arrangements which now exist. They can be tied to the institutional structures which have already been created in the regional development banks. For example, regional networks or lines of credit could be established or expanded before or during a crisis to act as a form of constructive contingent arrangement. The absence of an effective international lender-of-last resort also opens up the possibility for other forms of regional co-operation such as Japan's stillborn proposal for an Asian Monetary Facility, which should be resurrected in Asia and explored for other regions.

## Protecting against volatile capital flows

In the long-term, as greater regionalisation of trade and investment takes place across the developing world, more structured regional monetary integration through the development of currency blocs should be considered (though this might not always be practical in all cases). The existence of regional currency zones would provide more formal arrangements for countries to pool foreign exchange reserves as well as integrate banking and capital markets, and perhaps enter into monetary unions. They would also enable countries standing together to be in a stronger position to withstand speculative attacks. Precedents for this already exist in the Eastern Caribbean Currency Union and in the decision of the European Union to establish a common currency for the region, as well as attempts by other regional groups (such as in Western and Southern Africa) to move in the same direction.

## Developing a New International Architecture

In contrast to the way the 1994-95 Mexican crisis was handled, and the positive role played by the US in containing it, the East Asian crisis has been protracted and has spilled over to other regions because of Japan's inability to serve as an engine of growth in the region, and the reluctance of the major players to take the lead. Japan has already supported Asian currencies but its capacity to do more is now severely constrained. Since the Asian crisis has spread to other emerging markets, it is all the more necessary for the G-7 and the IFIs to act swiftly to achieve better global co-ordination of monetary policies by reducing interest rates and reflating the global economy in order to contain the crisis and avert the risk of global recession.

There is another important global dimension which needs to be addressed urgently. The present international monetary and financial system is inherently prone to crises due to inadequate arrangements for global economic governance and the absence of safety-nets which can be introduced when markets fail. There does not seem to be any concerted effort to agree a new architecture for the international financial system, which can cope with crises of the kind we are witnessing. Several piecemeal efforts have been made, but no tangible progress has been achieved.

The Group believes that serious discussions to develop this new architecture should be pursued to enable the defence mechanisms which are available to developed countries (and which were deployed in the 1987 and 1992 crises) to be extended to developing countries, and to examine the possibility of a credible lender-of-last-resort.

To be meaningful, these discussions need to be democratic involving representation from industrial, emerging and other countries at different stages of development. Such dialogue also needs to integrate concerns about growth and development into the discussion of international financial issues, since the ultimate purpose of stable and supportive financial systems and arrangements at national and international levels is to underpin the growth of output, employment and human progress. The Group, therefore, sees an advantage in a summit meeting of these different groups of countries and the IFIs to consider the shape of the new architecture. The Group recommends that Commonwealth Finance Ministers should consider the feasibility of a Commonwealth role in promoting such a summit meeting.

## ANNEX

**This Report served as the basis for the discussions of the Commonwealth Expert Group on protecting countries against the destabilising effects of volatile capital flows.**

### Introduction

There are many advantages and positive effects associated with the deep integration of countries into the global economy. The benefits of foreign direct investment are clear; it is not only more stable, but also brings technological know-how and access to markets. Other external flows also have important positive microeconomic effects, such as lowering the cost of capital for creditworthy firms. At a macroeconomic level, foreign capital flows can complement domestic savings, leading to higher investment and growth.

However, large surges of short-term and potentially reversible capital flows to developing countries can also have very negative effects. Firstly, these surges pose complex policy dilemmas for macroeconomic management, as they can initially push key macroeconomic variables, such as exchange rates and prices of assets like property and shares, away from what could be considered their long-term equilibrium. Secondly, and more importantly, these flows suffer the risk of very sharp reversals. These reversals – particularly if they lead to currency and financial crises – can result in serious losses of output, investment and employment, as well as increases in poverty.

In the case of the East Asian crisis, reversals of private capital flows have been dramatic. According to figures from the Institute of International Finance, the five East Asian countries hardest hit by the crisis (South Korea, Indonesia, Malaysia, Thailand and the Philippines) experienced in a single year a turnaround of US\$105 billion, accounting for more than 10 per cent of their combined GDP; the shift was from capital inflows of US\$93 billion in 1996 to an estimated outflow of US\$12 billion in 1997. Most of this dramatic swing resulted from a sudden loss of confidence in their economies leading to a sharp decline in commercial bank lending (which fell by US\$76.8 billion) followed by portfolio flows, while foreign direct investment remained constant.

This massive and sudden withdrawal of capital flows in itself caused a dramatic reduction in absorption, as well as very severe economic and

currency crises. In Asia, violent devaluation and large increases in interest rates implied that the currency crises interacted with banking crises, which led to the contraction of bank lending and a collapse in asset prices. Thus, by early February 1998, equity markets in Indonesia, Malaysia, the Philippines and South Korea had declined by 53 to 76 per cent from their 1996 or 1997 peaks in local currency terms. Meanwhile, the exchange rates in these economies fell by 40 to 70 per cent, measured in US dollars per unit of domestic currency.

### Analysis of the East Asian Crisis

A year after the East Asian crisis started, its financial and economic consequences have not yet been contained. In fact, the opposite seems to be occurring with other emerging economies – particularly in different regions – becoming affected. Furthermore, increasingly the East Asian financial crisis has been transformed in the affected countries into a serious crisis in the real economy. There have been substantial downward adjustments in output, income and asset values with consequent heavy socioeconomic damage which has disconcerting implications for political stability<sup>1</sup>. A number of affected countries (notably Indonesia) will lose a significant part of their previous growth gains, with long-term structural damage to their economic and social systems resulting from the successive shocks.

It is noteworthy that the East Asian crisis itself, as well as its depth and length, were almost totally unexpected. The speed and extent of contagion was especially unforeseen.

### Causes of the crisis

In examining the causes of the East Asian crisis, three key elements need to be noted which distinguish it from other crises.

1. According to J P Morgan's estimates for the first quarter of 1998, GDP fell – at the seasonally adjusted annual rate – by 24% in Indonesia, 19% in Korea, 23% in Malaysia and 5% in the Philippines and Hong Kong. Though the annual figures may be significantly better for several countries, the magnitudes of the contractions in the first quarter show the severity of the problem. Of particular concern is the fact that the poorer and more vulnerable groups in these countries will be the worst affected, even though they did not cause the problem. This is particularly unfair, given that those who caused the problem, are on the whole not affected.

Firstly, the roots of external imbalances were grounded largely in a rapid build-up of unhedged private sector debt which carried long-term transformation as well as exchange risks. Secondly, the crisis was a consequence of over-investment (though some of it may have been misallocated, especially in the property and electronic sectors) and not of over-consumption on the part of either the public or private sectors.

Thirdly, the crisis was triggered primarily by a sharp deterioration in confidence throughout the region and outside it. The crisis spread from Thailand and enveloped all of East Asia as a result of contagion, rather than any significant weakening in macroeconomic fundamentals, which were generally believed to be strong. Indeed, the most disturbing element in the crisis was that it affected countries with long track records of good economic management that had been remarkably successful over extended periods, in terms of economic growth, the dynamism of their export sectors, low rates of inflation and high rates of saving.

How were these economies suddenly shaken by such major currency and financial crises? Clearly, there were a number of emerging structural deficiencies and policy failures in the countries themselves: a "bubble effect" in their domestic financial systems and particularly in their banking systems, which were not appropriately regulated. There had been rapid growth and inadequate monitoring and regulation of short-term private debt, incurred both by banks and by corporate borrowers; an inconsistent exchange rate and monetary policies which induced the inflow of speculative funds; and premature and ill-conceived capital account liberalisation in many instances. Furthermore, several of the East Asian countries had fixed exchange rate policies with their currencies pegged to the US dollar; this policy became particularly problematic when the US dollar appreciated sharply vis-à-vis the Japanese yen between 1995 and 1997 causing deterioration in competitiveness in much of East Asia.

There is another crucial causal factor which has not been emphasised sufficiently in recent discussions and which affected the spread of contagion and financial market collapse across Asia. This relates to the role played by the "herd behaviour" of internationally mobile capital flows in triggering the crisis. This aspect is linked to certain imperfections of international capital markets, whose role has increased due to the speed generated by highly sophisticated information technology. Paradoxically, this impact appears to be strongest for economies that either are, or are perceived to be, in the process of becoming highly successful.

Successful economies offer high returns. If international investors' entry is facilitated by capital account liberalisation, they tend to rush in, generating a surge of capital inflows that affects key economic variables. Exchange rates become over-valued and the prices of key assets – like shares or real estate – rise quickly and sharply. Banks tend to relax lending standards, lifting the liquidity constraints of business firms, as they assume that current trends will continue. The current account deteriorates, often quite rapidly, as both consumption and investment rise. Initially, this is not seen as a problem, as foreign lenders and investors are willing to continue lending or investing.

However, investors' appetite for risk can change suddenly. The change may be due to domestic or international, economic or political, important or relatively small factors. This change triggers a sharp modification in perceptions, leading to a large fall in confidence in the economy among internationally mobile investors, both foreign investors and nationals able to take their liquid assets out. The change of perception tends to be both severe and quick. A country perceived as successful is suddenly seen as fragile, risky and crisis-prone. The change of perception tends to be far greater than the magnitude of an underlying change in fundamentals warrants. On the other hand, any weakness in economic fundamentals is magnified by markets. As in East Asia, there can be much overshooting; exchange rates collapse, stock markets and property prices also fall sharply.

This pattern helps to explain the currency and banking crises in the Southern Cone of Latin America in the early 1980s and the Mexican peso crisis in 1994. It also helps to explain the East Asian crisis and its contagion effects. While there are significant differences between the East Asian crises and the previous ones, the boom-bust behaviour of short-term lenders and investors, driven not just by real trends, but by dramatic changes in perceptions, is a common denominator; this also helps to explain why private sector crises are generally more difficult to manage than crises originating in public sector deficits. Another common factor is the complacency of the economic authorities in recipient countries during the period of boom. The damage that can be done by sharp changes in capital flows is far larger, when (as in East Asia) a high proportion of the inflows are short-term and easily reversible.

### **The Peculiarities of Financial Markets**

There are several factors which explain why capital and financial markets are different and prone to important imperfections. Factors

like asymmetric information and adverse selection play an important role in explaining these imperfections, given that these markets are particularly information-intensive and highly sensitive. Furthermore, there are strong incentives for “herding” in financial markets, as each individual short-term investor, lender or fund manager tries to choose the investment or loan that he/she thinks is most likely to be chosen by other investors or lenders, as their assessment will be a crucial element in determining short-term prices.

Another factor which is relevant to understanding the East Asian crisis is the phenomenon of self-fulfilling attacks: crises arise without obvious current policy inconsistencies. There is at present a limited understanding of what triggers self-fulfilling attacks. The main explanations given by market actors for different recent crises (e.g. the Mexican peso crisis and crises in different East Asian countries) tend to be rather different ones. As a result, developing country policy-makers face the daunting task of “playing to moving goal-posts,” to avoid crises. Naturally, there are conditions of vulnerability that can be identified (such as the ratio of short-term debt to foreign exchange reserves or high current account deficits). On the other hand, even if some of these indicators may be relatively low and/or improving (e.g. the current account deficit was relatively low and improving in South Korea in 1997), a country can still have a crisis. These patterns confirm the multiple-equilibrium character of currency and other crises, where a triggering event causes a dramatic change of perception that makes these vulnerability indicators become important and precipitates a large change of investors’ and creditors’ flows.

### Response to Crisis and Contagion

Another important set of factors explaining the depth, length and geographical extension of the East Asian crisis relate to contagion and mistakes in crisis management. Capital account-led crises, which relate to the expectations of private investors and lenders, need responses which are different from those responses to traditional balance of payments crises, associated with problems on the current account and caused by public sector deficits. In the “new style” of crises, increasing the confidence of private actors is absolutely central. In this new context, diagnosis and policy measures suggested by international institutions, which emphasise the negative structural features of the crisis-hit countries and overload programmes by requiring sweeping structural reforms in short periods as a pre-condition for financial disbursements, tend to exacerbate crises and contribute to a further

undermining of confidence; this is particularly true for structural reforms which are not central to stabilisation. Even essential structural reforms may be unnecessarily costly to implement if not properly sequenced and implemented quickly during a crisis. It must, however, be recognised that some decisive steps towards structural reforms are also necessary in order to create confidence. The scope of the programmes must, therefore, be limited to such reforms as are absolutely essential.

A second problem has been that Asian, and other, countries initially tend to postpone, for as long as possible, approaching international institutions like the IMF, partly because they fear that the Fund's required measures would be too draconian on stabilisation, as well as too intrusive on structural adjustment. Countries come to the Fund only when the situation has already deteriorated sharply, and the margin of manoeuvre for policy-making has become very restricted. Clearly, new and more positive dynamics of interaction between crisis-prone countries and the IMF need to be developed. Furthermore, in dealing with a crisis of confidence, policy conditionality by the IMF and other institutions needs to be designed primarily so as to restore the confidence of both foreign and domestic actors. Though excessively loose monetary and fiscal policies would be counter-productive, so are excessively tight monetary and fiscal policies which tend to seriously undermine both confidence as well as economic activity and investment. A key objective in the design of macroeconomic policies also needs to be the protection of the most vulnerable and poorest groups of society.

A further determinant of the protracted and deep nature of the East Asian crisis has been the inability of the Japanese economy to serve as an engine of growth for the region. Japan has already supported Asian currencies but its capacity to do more is now seriously constrained. This makes it all the more necessary for the G-7 and the International Financial Institutions (IFIs) to achieve better global co-ordination of monetary policies, as well as reflating the global economy in order to contain the crisis and avert the risk of global recession.

### Lessons for Crisis Prevention and Management

There are a number of important lessons that can be drawn from the proximate causes and management of the East Asian crisis.

The causes of the East Asian crisis are complex to identify. Explanations of the crisis often begin with a long list of the alleged problems of East Asian

countries. This leads to the fallacy of erroneous connection: any problem that existed prior to the onset of the crisis is seen automatically as its cause. To be convincing, the explanation provided has to be consistent with the past record of the region and clearly identify the specific factors that contributed to so dramatic a change from rapid growth to deep crisis. It is also necessary to separate factors that triggered the crisis from those that spread the crisis across the region through contagion.

The analysis of the crisis suggests that while it was triggered by speculative attacks on East Asian currencies, particularly where the currencies were overvalued, the depth of the contagion highlighted the build-up of vulnerabilities in the region's economies to reversals of capital flows. To an important extent the crisis also reflected market failures and inadequacies of risk assessments by international lenders and investors.

It is also important to recognise that growth is not always the answer; the manner in which it is financed is also critical. High growth rates in East Asia had masked certain weaknesses in financial systems. There was also a gross under-estimation of the speed with which markets can react, thus penalising any perceived transgression or deviation from prudent and sound macroeconomic and financial sector management.

The political and social fallout from the financial crisis was also pervasive across all affected countries, indicating that the political side of the economic equation and the influence of politics on economic policy cannot be ignored in the design of policy responses. Whatever measures are taken to contain the crisis and accelerate recovery, affected governments must give priority to restoring stability and confidence and coping with the social impact of the crisis.

A further lesson is that financial crises have a tendency to very easily turn into multi-country crises. Contagion can spread rapidly, causing currencies and stock prices to slide. The incentive to break exchange rate arrangements on risk/return trade-offs can create the problem of contagion because of shared trade, shared investors and shared characteristics among countries. Weak early warning signals can create political complacency which delays recognition of the scale of the crisis. One important aspect of contagion was the inability of markets to differentiate between different countries in terms of risk. For example, while Malaysia's economic fundamentals were still generally sound, it was finding it increasingly difficult to borrow.

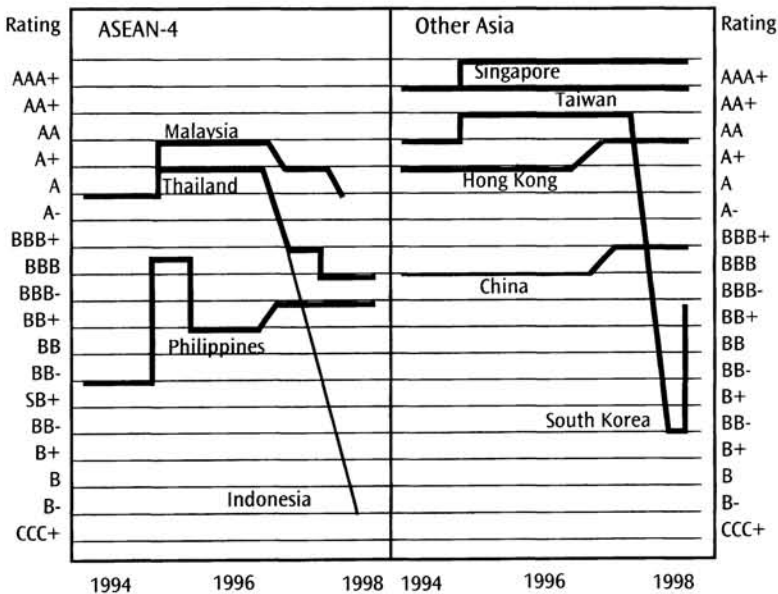
The onset of crisis in one set of countries can also introduce considerable uncertainty about where foot-loose capital will turn to

next. The key challenge, therefore, is to ensure that countries are adequately prepared to handle such capital diversions. For a number of low-income and small countries, effective crisis management may demand lending on soft terms to enable them to put in place social safety nets. In terms of signalling, markets appeared to be “asleep at the wheel” in monitoring latent risks in East Asia prior to the Thai crisis. Interest rate spreads gave no warning of impending difficulties. Credit rating agencies failed to adjust long-term debt ratings until after the crisis was under way, and then abruptly downgraded their rankings, thereby precipitating the crisis. (See chart below).

**Country credit ranking**

While the general view is that hedge funds and other institutional investors did not play a significant role in quantitative terms, it is important to note that their role is yet to be fully analysed, and that even a small change in such flows could easily destabilise a small market, the size of any of the East Asian stock markets.

**Standard and Poor’s: Long-Term Foreign Currency Rating of Countries**



Source: Goldstein, M and J Hawkins (1998) The Origin of the Asian Financial Turmoil

Close monitoring of financial markets and capital flows, as well as the speed of response, are crucial to prevent a liquidity crisis from turning into one of insolvency. Lessons were clearly not learnt from the Latin American crisis of the early 1980s where post-crisis actions were not taken promptly and a decade of growth was lost.

The East Asian crisis also demonstrates the pitfalls of premature and badly sequenced liberalisation of the capital account. While there is widespread agreement that this should remain an ultimate goal, it needs to be pursued prudently, and preceded by the development of the financial sector and strong macroeconomic fundamentals. It is imperative to establish basic pillars to regulate the financial system before capital controls are removed. Capital liberalisation and regulation of the financial system should move in tandem. There are no clear rules on what is an appropriate exchange rate regime, but over-valued exchange rates can act as an incentive to domestic corporations to borrow overseas. It is also a fact that misaligned exchange rates can play a self-fulfilling role.

The crisis also demonstrates that neither pegged nor flexible exchange rate policies provide a guarantee against currency volatility. If an exchange rate peg is being used to stabilise an economy, the country should think early about how to exit from it. If countries wait until a nominal peg is attacked, it will be too late to avoid a crisis by floating the currency. In such a case, countries could move much earlier to some sort of managed float, which can help avoid real appreciation.

Rapid sharp increases in interest rates could also be effective in some, but not in all, cases for preventing large currency depreciations. Such increases are never effective if they have to be maintained for very long. They can be particularly counter-productive in economies which are highly leveraged, as in East Asia, and convert what may essentially be a crisis of liquidity into one of insolvency. While some increase in interest rates may be necessary to provide a signal, this should be supplemented by slowing down credit growth, using ceilings on lending for property and using prudential regulations.

In seeking solutions to East Asian type crises it is important to take account of the microfactors behind currency speculation and its highly negative effect on systemic instability and on individual countries.

The recent crisis has also highlighted the moral hazard problem. Attempts to socialise private debt through the government assuming private sector obligations, point to the need for developing effective

processes to handle debt workouts and permit the use of “standstills” to delay debt repayments in exceptional circumstances. It is important that those engaged in speculation and risk-taking should bear the consequences of their actions, and should therefore be more fully involved, at an early stage, in achieving efficient burden-sharing vis-à-vis the official sector, thereby limiting moral hazard. In the absence of a lender-of-last-resort, priority needs to be given to negotiating orderly debt workouts with private creditors to ensure a more efficient outcome.

As regards crisis management, there is a need to take a more discerning view of the IFIs' role and their prescriptions. The crisis was partly aggravated by the way it was handled. For instance, it has been argued, the IMF did not anticipate the severity of the downturn; fiscal retrenchment was too severe, although the fiscal stance was relaxed later on; too little funds were committed to give confidence to markets; and programmes were too ambitious and overloaded with structural reforms which exacerbated a loss of confidence. There has, therefore, to be a balanced combination of stabilisation and structural reform measures. Structural adjustment programmes must be properly prioritised so that the most urgent and relevant measures are taken up first.

The IFIs were also not sufficiently involved in developing adequate social safety nets in the affected countries from the outset. They should have been more sensitive to social conditions before implementing measures like abolishing subsidies and closing banks. The failure to do so meant that social and political difficulties were further magnified with perverse effects on market confidence.

It is important for countries to increase transparency and to improve the timeliness, coverage and reliability of economic and financial information. However, the responsible use and accurate analysis by the market of the information disclosed, is equally important. The crisis has also revealed the need to further examine the causes of vulnerability and the nature of triggering events, in order to be able to predict risk and, above all, improve the prevention of currency crises.

Domestic policies in terms of sound macroeconomic policies, the strengthening of the domestic financial sector, and the possible regulation of short-term capital inflows can play an important role. However, they are not sufficient, especially in an increasingly integrated global economy. The present international monetary and financial system is inherently prone to crises due to inadequate arrangements for global economic governance and the absence of safety nets which can be activated when markets fail. There does not seem to be any concerted

## Protecting against volatile capital flows

effort to agree on a new architecture for the international financial system, which can cope with crises of the kind we are now witnessing. Therefore, serious discussion to develop this new architecture should be pursued in order to enable the defence mechanisms which are available to developed countries (and which were deployed in the 1987 and 1992 crises) to be extended to developing countries, and to examine the possibility of a credible lender-of-last-resort.

It is important to avoid drawing the wrong conclusions from the crisis by over-regulating capital flows; global capital flows should still be treated as an opportunity, not as a threat, although they need to be skilfully managed. These lessons suggest that a comprehensive strategy for managing the volatility of private capital flows needs to be directed at four levels: national actions to reduce the likelihood of future crises; regional actions to limit damage in the immediate neighbourhood; actions by the international community to co-operate effectively in preventing and/or managing future crises when and if they happen; and, finally, strengthening international regulatory frameworks in order to enhance global stability.

### Crisis Prevention

As crises are costly and spill over swiftly into other countries, the utmost priority needs to be given to crisis prevention measures. The foundation for these measures must be grounded in the country in sound macroeconomic, structural and social policies, which establish the basis for sustained growth and development. A number of proposals are currently being discussed, three of which have received much attention recently: improvements to the quality of information, together with improved surveillance; the strengthening of domestic financial systems and increasing financial sector transparency; and encouraging the "prudent and properly sequenced" liberalisation of capital flows. The feasibility of these proposals is considered first before focusing on a number of other measures which are considered to be crucial for an effective crisis prevention strategy.

### Transparency and the disclosure of information

The East Asian crisis has provoked new calls for improvements to information disclosure, data dissemination and international surveillance. Similar demands were made after the Mexican peso crisis, when the emphasis was placed on better information regarding

national economic policy. The current emphasis is on improving data in other areas such as foreign exchange reserves, short-term foreign currency denominated debt, and the state of the financial system. The question of accurate information is made even more complex due to the increased use of off-balance sheet transactions such as forward contracts and other financial derivatives. The East Asian crisis has highlighted this issue as the true foreign exchange positions of some countries were hidden by central bank derivative transactions and positions. Hence, the improved capacity of developing country regulators to keep up-to-date with these devices, especially in the context of liberalised financial systems, would be particularly valuable.

Transparency and the timely release of economic information are also important. In order to encourage transparency in emerging market economies, the Fund has been authorised to delay the completion of its annual Article IV assessment of a country's economy if it is not satisfied with the information being disclosed. It has also been asked to encourage more emerging market economies to make public the results of Article IV consultations through the issuance of Press Information Notices (PINs) on the IMF website. The IMF's surveillance is being made much tighter and more far-reaching, particularly with respect to the financial sector. The East Asian crisis has also led to calls by the G-7 that the IMF be obliged to inform the markets when it thinks a country is heading for a crisis<sup>2</sup>. The role of the Fund as a "whistle blower" is, however, fraught with danger: it could give rise to conflicts of interest; seriously compromise the Fund's position as a confidential adviser to member countries; and may also provoke the very crises it is trying to prevent.

More importantly, even if information and transparency were to be greatly improved, it is doubtful that this will necessarily lead to the removal of the threat of market over-reactions or address the vulnerabilities of economies. It has been shown that prior to the East Asian crisis, investors and lenders were well aware of some of the problems the worst hit countries were experiencing. Yet, they did not adjust their lending and investment until the crisis hit. Similarly, early warning indicators are unreliable and often lag behind an unstable dynamic process. Thus, by the time available indicators are visibly out of line, it is usually too late to attempt to prevent a crisis.

2. It is often argued that markets judge countries according to their fundamentals, and crises usually occur because of some change in fundamentals caused by external shocks or policy mistakes. However, evidence shows that in the case of both Mexico and the East Asian countries, there were no changes to fundamentals significant enough to account for the severity of the crises which occurred.

## Protecting against volatile capital flows

While the focus of current proposals for improved transparency and surveillance is the recipient country, it is clear that market participants should also analyse and interpret correctly the large amounts of data being released by national authorities. Greater attention also needs to be given to the risks posed by potential large reversals of capital flows, and the role played by financial markets, including currency traders and hedge funds, in influencing currency and asset price movements in thin and imperfect markets which are particularly vulnerable to attack. The possibility of extending large trade and position reporting systems (now practised in the futures trade) to cover currency trading and hedge fund activity should be explored. Just as timely and accurate information on the macroeconomic and financial situation of a country is necessary to facilitate decision-making in financial markets, a more transparent market structure and operation would enable governments in both recipient and source countries to implement market-responsive regulations and policies. If better monitoring and understanding of markets are to be achieved, government regulators and international institutions should build on the current practice of greater dialogue with traders and private financial institutions.

### Strengthening domestic financial systems and supervision

Financial sector weaknesses are often a major contributing factor in countries experiencing macroeconomic difficulties. Strengthening domestic financial systems should, therefore, be a core element in crisis prevention. The key aspects of a sound financial system include: transparency of the financial system; competent management; effective risk control systems; adequate capital requirements; lender-of-last-resort facilities; prudential regulation; a supervisory authority with sufficient autonomy, authority and capacity; and supervision of cross-border banking<sup>3</sup>.

However, establishing effective risk management and sound regulatory and supervisory systems is a huge task. Even the most advanced countries fall considerably short of the ideal. The building of robust financial systems in developing countries is an even more complex process.

3. In 1997, the Basle Committee on Banking Supervision published its "Core Principles for Effective Banking Supervision", developed by a working group consisting of representatives of the Basle Committee and emerging market countries. In 1998, the IMF published "Towards a Framework for Financial Stability", which was designed as a first step in building a framework that could be used in the Fund's surveillance of its members' financial sectors. The IMF's work on financial systems has focused on the banking system, due to its primary role as a financial intermediary in many member countries and the limits of staff expertise. However, other institutions such as the International Organisation of Securities Commissions (IOSCO), have been compiling "best practices" for their sectors of the financial system.

In the meantime, we need to be realistic and recognise that developing countries have less capacity for financial regulation and a greater vulnerability to shocks. Hence, in countries which exhibit signs of weakness, it would be prudent for the regulatory authorities to consider the likely effects of major economic changes such as would occur in a currency crisis, and to apply risk weightings and other key variables dynamically.

There is also a need for effective surveillance of domestic financial systems in all countries. Recent events have clearly demonstrated that domestic financial sector problems can spread internationally. It is, therefore, in the interest of all countries that proactive steps are taken to ensure stability nationally and internationally.

Because of the limitations of staff resources and expertise, the IMF's surveillance in this area primarily focuses on identifying weaknesses in the financial systems of countries which could have a significant impact on their macroeconomic situation.

The Fund, at present, cannot adequately oversee the regulatory and supervisory authorities in each country, or address problems in other areas of the financial system. In this context, the Canadian proposal, known as the "international supervisory and surveillance initiative", is of interest and needs to be considered seriously. It calls for the establishment of new international arrangements to improve the supervision and regulation of domestic financial systems, and to identify financial sector problems before they become international crises. The proposed arrangements, which would involve close collaboration with the Bretton Woods Institutions and the Bank for International Settlements (BIS), would bridge the roles that surveillance, peer pressure and support can play in encouraging countries to build strong financial systems according to international standards.

### Capital Account Liberalisation

A third strand in the IMF's crisis prevention strategy concerns encouraging countries to liberalise capital flows in "a prudent and properly sequenced way". In the sequencing of capital account liberalisation, a number of minimum pre-conditions need to be met, including a sound macroeconomic policy framework and reform of the international financial system, as well as adequate regulatory and supervisory arrangements which operate effectively. However, more work is needed in order to define clearly appropriate pre-conditions, timing and sequencing for successful capital account liberalisation. A

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Careful assessment of costs and benefits of capital account liberalisation is also needed, before capital account liberalisation is encouraged. The recent developments in East Asia have highlighted the problems and costs that can result when fragile emerging market economies prematurely open their capital account. They have also indicated the need for great caution in proceeding with further capital account liberalisation at a country level. This should be introduced in phases with liberalisation and strengthening of the domestic financial system moving in tandem. It also follows that (in the event of an amendment to the IMF Article relating to capital account issues) countries should have the necessary flexibility to temporarily reverse liberalisation measures if a change in macroeconomic or political conditions, whether at home or abroad, should call for it. In particular, countries should be able to use measures to discourage surges of short-term flows, with a preference for market-based measures.

### Regulating and/or taxing capital inflows and outflows

The three main proposals examined so far, namely, improvements to the quality of information and surveillance, strengthening domestic financial systems, and the prudent liberalisation of capital accounts, would all contribute to strengthening the international financial system. Shaping an effective crisis prevention strategy, however, will require a sharper and more comprehensive array of tools than have been proposed so far.

This section examines measures that recipient countries can take to discourage excessive surges of short-term and easily reversible capital flows. In particular, they should be wary of short-term foreign currency borrowing by banks and corporates and consider using market-based discouragements. Indeed, some countries (e.g. Chile and Colombia) have been fairly successful in implementing measures (such as taxes and non-remunerated reserve requirements involving interest-free deposits with central banks, on flows during a fixed period) with this objective in mind. Their aim has been threefold:

- to change the structure of capital inflows, by increasing the share of foreign direct investment and long-term loans within total capital flows and decreasing the share of short-term and potentially reversible flows, by discouraging the latter;
- to increase the autonomy of domestic monetary policy by creating a wedge between domestic interest rates and international ones; and

- to help curb large over-valuation of the exchange rate, caused by a surge, which discourages exports and poses the risk of growing and unsustainable current account deficits.

There is growing evidence that measures to discourage excessive inflows – in countries like Chile and Colombia – have contributed to relatively more successful management of capital inflows. These measures are also widely seen as one of several reasons why these two countries were amongst the few in Latin America to be relatively unaffected by the tequila crisis in 1994-1995 and by the East Asian crisis. Two of the attractive features of Chilean-style measures are: (a) they are market-based rather than quantitative, and (b) they apply to practically all short-term flows, thus simplifying administrative procedures and reducing possibilities of evasion. Other domestic measures can also be useful for discouraging excessive short-term flows, such as modifying withholding taxes on companies' "external" borrowing or tax credits to encourage long-term capital flows.

The major international financial institutions now explicitly recognise that, despite some limitations and minor microeconomic disadvantages, market measures taken by recipient governments to discourage surges of short-term capital flows can play a positive role, if they are part of a package of policy measures that include the establishment of sound macroeconomic fundamentals, as well as a strong and well-regulated domestic financial system. International institutions need to undertake further work on the feasibility of such measures, and assist governments in emerging markets to design appropriate instruments and contingency measures which could be suitably applied at times when countries are receiving excessive inflows of short-term capital, and when other key conditions are in place. While market-based measures directed at regulating capital inflows are to be preferred, it may be necessary for countries to consider a careful application of capital controls of an administrative character or exchange controls, on a temporary basis, in the event of a crisis as serious as in East Asia. Such controls would seem to be justified in exceptional cases where the costs of any resulting distortions are likely to be lower than the alternative of an economic slump which progressively worsens.

Other market-based solutions can also be explored to discourage currency traders from taking short positions on currencies of individual emerging countries. While the market uses a myriad of instruments, central banks tend to limit themselves to traditional instruments. If they were to use the opportunity of capital inflows to take advantage of financial insurance instruments, they could consider creating

incentives for market participants to refrain from speculating against the local currency in times of trouble. When large international banks request banking and securities licences, governments could insist that one condition for granting such licences would be for the central bank to buy (for a modest fee) from these banks, some insurance against future currency volatility with a call option on the existing value of the dollar vis-à-vis the local currency. This would oblige the seller of the option (the international bank) to sell at a future time to the central bank, a pre-agreed volume of dollars at the existing exchange rate. If at a later date the currency came under pressure, the international bank would be obliged to buy dollars in the market at the new rate and sell them to the central bank at the original rate, thus incurring the risk of losses on its own speculation. To avoid such losses, international banks who had sold dollar call options to the central bank, would have a strong incentive to avoid currency speculation that could result in the devaluation of the local currency. This is a new proposal; it has not been studied thus far and requires further examination, both in terms of its practicability and its impact on the cost of capital.

### **The role of counter-cyclical policies**

The role of counter-cyclical monetary and fiscal policies of capital-receiving countries in regulating capital inflows is also important.

During a period of excessive surges of capital inflows, recipient countries have greater degrees of freedom for policy-making than when capital is flowing out. A tightening of macroeconomic policies is particularly desirable when indicators of vulnerability to currency crisis point to rapid deterioration, or pass certain prudential thresholds. Such indicators include: when current account deficits start to grow rapidly and exceed 3-4 per cent of GDP, when the proportion of those capital flows, which are easily reversible, in total flows is high and rising and, particularly, when short-term external liabilities grow rapidly and start approaching the same level or even exceed foreign exchange reserves. Thus, adequate levels of foreign exchange reserves and limits on the level of short-term external liabilities are crucial for the avoidance of currency crises.

Besides prudent monetary policy, an appropriate exchange rate regime with a consistent internal interest rate regime are also essential to make economies less vulnerable to currency attacks. Although the choice of the exchange rate regime should be linked to the country's specific circumstances, for those which rely heavily on external capital flows some sort of managed float can help avoid real appreciation. Fixed exchange

rates, even though they have some advantages, offer apparently secure yields to very short-term investors, leading to surges of such inflows. They can also create fixed goalposts for hedge funds and others to attack, when the situation deteriorates. If countries wait until a nominal peg is attacked, it will be too late to avoid a crisis by floating the currency.

A counter-cyclical approach should also be applied to the supervision and regulation of the banking system. In boom times, the supervision and regulation of banks – as well as credit decisions by the banks themselves – should not be based only on borrower expectations of a continued growth scenario. The potential downside risks also need to be considered. This counter-cyclical approach would moderate booms of domestic bank lending which exacerbate the impact of surges of capital inflows.

### Crisis Management

Once a country enters into a crisis, it usually cannot cope on its own and international assistance has to be called in to mount a rescue effort. Each situation has its own dynamics, but there are a few obvious lessons to be drawn from recent experience.

#### **The role of the IMF and World Bank**

The first response internationally when a large currency crisis starts unfolding in one or more countries, is to activate quickly a sufficiently large and credible injection of official liquidity to provide the important public good of stability. The IMF has been, and is likely to continue to be, the key institution for performing this function, using its own resources and its catalytic role in attracting other resources, both public and private. Given the large scale of the resources required, and the limitation of the IMF's resources, the capacity of the Fund to address the projected liquidity requirements of emerging markets in future years remains very much in doubt. Increases in IMF quotas and possibly further issues of SDRs are minimum necessary steps to rebuild a credible multilateral liquidity system. Meanwhile, complementary avenues for sufficient provision of early liquidity need to be explored urgently. One possibility is enhanced central bank co-operative arrangements through greatly enlarged swap arrangements, particularly between G-10 members and non-members, and within regions. Another is to have pre-committed standby arrangements with private banks, as Argentina and Mexico have recently done. However, these latter arrangements are still untested, and it is unclear how well they

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would operate in a severe crisis. To be effective for restoring confidence, the liquidity provided needs to be large. It is important that in handling currency crises, an appropriate combination of adjustment, financing and, if necessary, debt workouts be adopted (for the latter, see below). Also, an appropriate combination of additional resources needs to be provided to the IMF for stabilisation, and to the World Bank for dealing with the social effects of crises.

A number of issues arise relating to the IMF's role in providing liquidity. Besides the crucial issue of the scale of its resources, other issues include timing, conditionality and ways to avoid moral hazard. Timing is important since currency crises happen so suddenly. Although the IMF and the international financial community have made important efforts to develop emergency procedures, the response is still not fast enough. Given the incredible speed with which markets move today, loans need to be activated as soon as a crisis breaks out. Due to contagion, the crisis can spread rapidly to other countries. To deal with this problem, countries should be able to have increasing recourse to IMF-supported preventive programmes (or prior authorisation of subsequent "automatic" access to resources). This implies that a request by a country to borrow from the IMF should be made before a crisis occurs. The country would only draw on this facility if a crisis occurred, but it could do so immediately. This would imply that the Fund would have a "shadow programme" with the country, including policy conditions that would make a currency crisis less likely; these would be less stringent than would be called for in a crisis.

An additional serious problem particularly relevant for low-income Commonwealth countries, is that when such large volumes of IMF – as well as World Bank and regional development bank funding is channelled towards middle-income countries in crisis, funding available from these institutions for low-income countries can fall drastically. This also raises the issue of how the system will respond to financial crises in small and poor countries in Africa, Central America and the Pacific, who have virtually no access to alternative sources of funding in crisis circumstances. It is important that official support from the IMF and others should also be provided to "less important" countries in the same way as it is provided to those whose problems pose "systemic threats" to the health of the global financial system. It is therefore important to introduce greater flexibility in access to the IMF's emergency financing mechanisms, as well as to IDA resources, to assist these countries in times of crisis.

Two types of measures can help alleviate the pressure on the IMF to provide international liquidity. The first is to reduce the likelihood of

currency crises, with preventive measures along the lines discussed above. The second is to attempt to have more efficient burden-sharing between the public and private sectors. This makes it very important to develop orderly workout procedures.

Last, but certainly not least, is the nature of Fund and Bank conditionality that should accompany the large financial packages to meet the dangers posed by currency crises. It is crucial that such conditionality is designed to restore stability and market confidence as quickly as possible without damaging growth in the affected countries. Also, as far as possible, IMF conditionality should focus on macroeconomic policies, and not be too intrusive and broad. Only where additional structural reforms are essential for confidence-building, and can be implemented effectively in the short-run, should they be included as a part of policy conditionality. Other structural reforms could be undertaken later, once stabilisation has been achieved and growth restored.

Such an approach would help address a number of the criticisms that have been made about IMF conditionality. For example, it has been argued that IMF conditionality has been too intrusive and comprehensive, attempting dramatic structural changes in very short periods even before stabilisation has been achieved<sup>4</sup>. It has been further argued that the conditionality has not been appropriate in important aspects (e.g. indiscriminate bank closures, excessive tightening of fiscal policy, and over-emphasis on full debt repayment) and that even some of these measures and the pace of their implementation have “added to, rather than corrected, the panic”<sup>5</sup>.

On macroeconomic policy, the key challenge for IMF (and country) programmes is to design appropriate macroeconomic responses for currency crises that mainly originate in private sector imbalances, and not, as traditional IMF packages were designed to deal with, public sector imbalances reflected in fiscal or current account deficits. They should aim, first and foremost, at stabilisation and the restoration of market confidence before tackling longer-term issues.

### **Bailouts, standstills and orderly debt workouts**

The Asian crisis has lent a sense of urgency to the search for ways to manage financial crises more effectively. Given the scale of capital

4. Fedstein Martin (1998), “Refocusing the IMF”, *Foreign Affairs*, March/April 1998.

5. Radelet Steven, and Sachs Jeffrey (1998), *The Onset of the East Asian Financial Crisis*.

flows in the 1990s, public funds can no longer be relied upon to finance the private outflows during a crisis. In response to this situation, as well as to increased concern over moral hazard issues, a more efficient means of burden-sharing is required, with the banks and investors taking more of the responsibility for the ongoing provision of loans or credit to borrowers in crisis-affected countries.

Moral hazard occurs when the party that assesses the level of risk of a given transaction receives the gains from, but does not bear the full costs of, the risks taken. The need to reduce moral hazard, however, does not imply that policymakers should do nothing; the problems involved in collective action and the risk of contagion are justification for official intervention in crises. The problems of collective action were clearly illustrated during the 1980s debt crisis, when protracted debt negotiations were an important factor in delaying recovery in Latin America. Another example is that of Indonesia in the current crisis, where it took six months for the country to reach agreement with foreign banks on a private-sector debt restructuring programme. During the intervening period, the Indonesian economy deteriorated to the point that what was considered to be a crisis of liquidity turned into one of solvency.

There is clearly an urgent need for early agreement on orderly debt workout procedures, which can help bring about the rapid resolution of crises, while reducing the scale of official financing needed. This can be done by encouraging a greater assumption of risk by the private sector, as well as by involving the private sector at an early stage in crisis resolution through efficient burden-sharing. In a short-term liquidity crisis, as in East Asia, the timely provision of significant further credit could avoid the imposition of unnecessarily severe austerity measures on affected economies. In such cases, the official sector, rather than bailing out private creditors, could bail them in by enforcing early debt negotiations. Private creditors could be encouraged to retain their exposure, and to restructure their short-term credits over a longer period, as a pre-condition of official support.

The enforcement of "standstills", or temporary payment suspensions, should become a necessary and early part of the crisis resolution process. The threat of a payment suspension would encourage creditors to seek rapid debt renegotiation. Consensually agreed protocols for payment suspension, as part and parcel of crisis management, need to be designed to encourage creditors to agree to rapid debt renegotiation on appropriate terms. This will also require agreement on the trigger points at which such measures can be invoked. If it becomes accepted international practice for governments to impose a standstill as part of a

process of co-operative and non-confrontational debt renegotiation, creditors would have no reason to penalise them. Moreover, it would discourage irresponsible lending by commercial banks.

It is unfortunate that although orderly debt workout initiatives were endorsed by the G10 in 1996, nothing came of them when the Asian crisis began in the summer of 1997. It is imperative that significant progress is made in implementing these initiatives for managing financial crises before the next one occurs. The official sector should now press for the inclusion and implementation of contract clauses in commercial bank loans, bonds and other credit instruments, to facilitate orderly restructuring of securitised and commercial debt. At the same time, the IMF should signal its approval of the process by agreeing to lend into arrears to countries whose policies and prospects are considered acceptable.

### **Dealing with the social impact of crises**

The World Bank, other IFIs and bilateral donors should act early and on a sufficient scale to help countries deal with the social implications of financial crises. Within crisis-affected countries, the immediate protection of public expenditures for social programmes, food security and safety nets is essential, and the programmes agreed with the IFIs need to have adequate funding. The IFIs and bilateral donors were not sufficiently involved in addressing social impacts in the affected East Asian countries from the outset. Failure to do so resulted in social and political difficulties being magnified with further perverse effects on market confidence.

### **Crisis containment, reversal and recovery**

It is essential to achieve a reversal of economic recession and restore growth in the most affected countries:

- In the short-term, one of the key tasks facing countries affected by the crisis is to restore confidence in the economy. This in turn requires influencing and changing the direction of market expectations by giving clear “signals” that they are sincere in their efforts to implement fully financial sector reforms with all the institutional changes that this implies. This, along with other measures, will determine how quickly currencies are stabilised and the speed with which interest rates can be brought down.

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- The gradual relaxation of monetary and fiscal policies, which is being introduced in the affected countries, will further help to stop economic decline; if prudently implemented this may well restore market confidence. The extremely high rates of investment justify an emphasis on cutting investment rather than consumption.
- The speed, scope, and strength of reforms in the affected countries are likely to be influenced by political and social considerations in addition to macroeconomic ones. To deal with the social and political aspects of the crisis, special interventions will be needed, with financial support from the IFIs, to help develop social safety net provisions for those likely to be impoverished by the crisis: not only the newly unemployed, but also others who will suffer from reduced markets and rising prices. In the East Asian context, these people are especially vulnerable, given the region's weak safety nets and declining fiscal revenues for social programmes.
- Dealing with contagion is another major challenge. Since contagion can set back reform in the affected economies, it is imperative that the reform process is co-ordinated among crisis affected countries to ensure that slippages in one or two countries do not hold back recovery in others.

There are a number of other key issues that require attention on the supply side. First and foremost, countries need to adopt measures that lead to the provision of adequate working capital to corporations to permit them to take full advantage of competitive exchange rates to maximise their export potential. Export credit facilities need to be established. Secondly, actions to get international lenders to roll over and restore lending will have to be negotiated at the earliest possible point in time. Thirdly, it is important to restore the health of the banking sector through a recapitalisation of banks. Recapitalisation via a bond issue to the non-bank private sector, administratively-enforced credit rollover and reflation of the economy are three ways of dealing with the problem. The last option would require the introduction of some form of temporary controls on outward capital movements, which the international community will need to support.

### **Filling regulatory gaps in the international system**

The foregoing analysis leads us to four suggestions for filling regulatory gaps at the international level.

Firstly, in developing an international regulatory regime, it is important to take into account the different experiences and circumstances of countries. Recent experiences demonstrate that the way in which the global financial system operates is not always well understood by governments, nor for that matter by the IFIs. "Miracle economies" in one month can suddenly be denigrated as bastions of "crony capitalism" the next. Such selective and fickle perceptions need to be corrected or avoided. There is no reason to force all countries into the same rigid or standard regulatory mould. Instead, regulatory regimes and policy frameworks that are developed internationally should be flexible enough to accommodate different models of market economy and financial systems.

Secondly, regulations to deal with inward surges of short-term inflows in recipient countries alone will not be enough. It is also important to ensure a degree of symmetry in international prudential supervision and regulation in source countries, and to adapt it to the new scale and nature of private flows. There are two categories of flows to emerging markets where additional international and/or source country regulation and supervision may be necessary: short-term bank loans (particularly culpable in the 1982 debt crisis and in the 1997 Asian crisis); and easily reversible portfolio flows (especially important in the Mexican peso crisis) which are invested in exchange riskproof instruments. International bank loans (including short-term ones) are already regulated by industrial countries' central banks and co-ordinated by the Basle Committee. However, existing regulations are clearly not sufficient to discourage excessive short-term bank lending. For example, for non-OECD countries, loans of residual maturity of up to one year have a weighting of only 20 per cent for capital adequacy purposes, while loans over one year have a weighting of 100 per cent. As a result of this rule, short-term lending is more profitable for international banks. A narrowing of this risk differential by raising the premium for short-term lending would therefore be desirable.

In the case of portfolio flows to emerging markets, at present there is no regulatory framework internationally for taking account of market or credit risks for flows originating from institutional investors in developed countries, such as mutual funds (and more broadly for flows originating in non-bank financial institutions). However, this is a new and contentious topic and it is important that any regulatory proposals in this area should emanate from guidelines formulated by a working group consisting of representatives of source as well as emerging market countries, as was done in developing the Basle Core Principles.

Thirdly, the East Asian crisis has highlighted the need to establish or upgrade domestic "financial safety nets" through internationally agreed

standards or best practice. Such safety nets would consist, inter alia, of deposit insurance schemes, lender-of-last resort policies and policies for extending solvency support and exit policies, including prompt corrective actions and orderly closure of insolvent financial institutions. The Asian crisis has shown the danger of allowing insolvent financial institutions to remain operative. This has increased the size of losses and their impact on the economy. Lender-of-last-resort roles were played by East Asian central banks without government guarantee, thereby weakening the central banks. Deposit insurance schemes in some cases offered excessively broad coverage, while in others they were narrow. Properly conceived domestic financial safety nets would reduce the probability of financial crises, curtail their duration and expansion when they occur and facilitate crisis management. In addition to promoting greater financial stability domestically, they would also contribute to limiting contagion effects. Internationally agreed standards represent independent benchmarks against which transparency and accountability of national policies and practices can be compared. Despite significant progress, their development is incomplete. Current efforts need to be directed particularly at developing or improving the implementation of international standards relating to banking supervision, securities and derivative market regulation, insurance supervision, auditing and accounting bankruptcy, fiscal transparency and corporate governance.

Fourthly, it may be timely to examine further the feasibility of cross-border taxes on currency transactions as one way of moderating speculation in currency trading. The problems which arise with the implementation of such proposals raise serious doubts about their efficacy. However, the degree of speculation that has taken place in the recent crisis and its serious negative consequences have raised acute concerns. It therefore seems appropriate to continue efforts to explore how market-based disincentives might be created to discourage excessive speculation. Furthermore, in seeking solutions to East Asian-type crises, it is also important to take account of the micro factors behind currency speculation which exacerbate its highly negative effect on systemic instability. This suggests the need for the introduction of better internal risk assessment systems. Managing risk in large financial institutions that create and trade complex financial instruments, as well as take positions in a variety of currencies, is an extremely difficult responsibility to carry out. Systems are needed that allow financial institutions to measure not only their aggregate credit exposures, but also, to measure, on a day-to-day basis, their aggregate price and interest rate risks across financial markets. Individual loan officers, currency traders and sector managers do not generally see the

overall exposure, which is why internal risk management is a separate function of the central management of financial institutions, and one that needs to be timely and effective in tempering the enthusiasm of lending personnel when exposure becomes excessive.

Finally, further examination is required to detect and cover any other existing monitoring and/or regulatory gaps, in three major areas. The first relates to instruments such as derivatives and institutions such as hedge funds. The second concerns the need for an independent peer review of the methodology and modus operandi of credit rating agencies, whose sudden retrospective changes in country ratings can reinforce market volatility and create perverse expectations. The third concerns the need for a better understanding of recent changes in global credit and capital markets, and of the criteria used by different categories of market actors – including banks, mutual funds, hedge funds and others – to go in and out of countries as well as the incentives that explain these patterns.

### **Beyond Crisis: Additional Challenges**

#### **Developing a new international financial architecture**

There is also another important global dimension which needs to be addressed with urgency. The present international monetary financial system is inherently prone to crises due to inadequate arrangements for global economic governance and the absence of safety – nets which can be introduced when markets fail. There does not seem to be any concerted effort to agree a new architecture for the international financial system which can cope with crises of the kind we are witnessing. Several piecemeal efforts have been made but no tangible progress has been achieved. Hence, serious discussions should be pursued to enable the defence mechanisms which are available to developed countries (and which were deployed in the 1987 and 1992 crises) to be extended to developing countries, and to examine the possibility of a credible lender-of-last-resort.

To be meaningful, the process of discussion and decision-making on the new architecture needs to be democratic and broad-based, involving representation from industrial, emerging and other countries at different stages of development. The debate also needs to integrate concerns about growth and development into the discussion of international financial issues, since the ultimate purpose of stable and supportive financial systems and arrangements at national and

international levels is to underpin the growth of output, employment and human progress.

### **Regional initiatives**

In policy discussions on the East Asian crisis, not enough attention has been paid to the potential role of regional arrangements and mechanisms in crisis prevention and management. In coping with financial crises, there can be little doubt that regional arrangements can play an important “mezzanine” role between the national and international institutions. This would be easiest among countries with a clear regional identity. The absence of suitably designed regional arrangements (except in Europe) in the present array of institutions, facilities and instruments which exist to combat such crises, reflects a serious gap in the international financial system. Precisely what such arrangements should be, will inevitably depend on the particular characteristics, needs and circumstances of the countries in each region.

Clearly, a comprehensive set of arrangements – with matching institutional capacity – would need to encompass the following functions and capacities<sup>6</sup> : i) surveillance and early warning capacity coupled with the institutional ability to exert peer pressure in inducing essential policy changes and course corrections swiftly and effectively; ii) the capacity to avoid repeated rounds of competitive devaluations from occurring in neighbouring countries and preventing countries from adopting beggar-thy-neighbour policies to exit from a crisis likely to engulf the region; iii) sufficient intervention capacity in currency and financial markets to restore market confidence and forestall the prospect of free falls in currency or financial markets; iv) the ability to provide sufficient post-stabilisation liquidity and long-term finance in tandem with multilateral and regional development banks, to prevent disruptions to financial systems, economic growth and social stability at critical junctures in the stabilisation and adjustment processes; and v) the collective capacity to induce essential longer-term structural changes in financial markets and institutions, and to promote greater capacity for self-regulation and prudential behaviour on the part of private sector institutions as well as national regulatory authorities.

Such arrangements can complement, to an important degree, the global arrangements which now exist. They can also be tied to the institutional structures which have already been created in the regional development banks. For example, regional networks or lines of credit

6. Mistry Percy (1998), “Coping with Financial Crises: Are Regional Arrangements the Missing Links”, UNCTAD forthcoming.

could be established or expanded before or during a crisis to act as a form of constructive contingent arrangement. The absence of an effective international lender-of-last-resort also opens up the possibility for other forms of regional co-operation, such as Japan's still born proposal for an Asian Monetary Facility which should be resurrected in Asia and explored for other regions.

In the long-term, more structured regional monetary and exchange regime integration through the development of currency blocs should be considered (though this would not be practical in all cases). The existence of regional currency zones would provide more formal arrangements for countries to pool foreign exchange reserves as well as integrate banking and capital markets, and perhaps enter into monetary unions. They would also enable countries standing together to be in a stronger position to withstand speculative attacks. Precedents for this already exist in the Eastern Caribbean Currency Union and in the decision of the European Union to establish a common currency for the region, as well as attempts by other regional groups (such as in Western and Southern Africa) to move in the same direction.

# PROTECTING AGAINST VOLATILE CAPITAL FLOWS

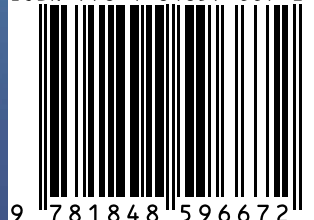
This publication is the result of a meeting in Mauritius in 1997, where, at the Commonwealth Finance Ministers' request, an Expert Group was convened by the Secretary-General to recommend measures to protect countries from the destabilising effects of volatile capital flows. The Expert Group, chaired by Mr Chris Liebenberg, met in London in 1998.

Protecting Against Volatile Capital Flows summarises the Expert Group's conclusions and recommendations, including the six main lessons to be drawn from the East Asian crisis and how to reduce the probability of future crises, in terms of strengthening the surveillance of domestic financial systems in all countries, creating social safety nets, and encouraging regulatory measures. The detailed Report which was the basis for the Expert Group's discussions can be found in the Annex.



Commonwealth Secretariat

ISBN 978-1-84859-667-2



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