Strengthening the International Financial System: Key Issues

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Summary. — There has been notable progress in reforming the international financial system in order to improve the resilience of the world economy to volatility in international capital flows. This paper focuses on three critical issues central to the effort to reduce the frequency and virulence of crises: (a) exchange rate regimes, both amongst major industrial countries and for emerging market economies; (b) capital account liberalization, whether and how it should be done; and (c) the role of IMF lending in crisis prevention and management, and in particular the critical question of how to involve the private sector in the resolution of financial crises. © 2000 Published by Elsevier Science Ltd. All rights reserved.

1. INTRODUCTION

Much has been written on reform of the international financial architecture in the wake of the financial crisis that for a short time in the fall of 1998 seemed likely to engulf most of the world economy. Just as the crisis was driven by the capital account, so too the proposed reforms center around capital flows and how to tame them.

There are two main reasons for this focus. First, international capital flows to emerging markets have been extremely volatile, subjecting recipient countries to large shocks, and contributing to the massive recessions in the East Asian crisis countries in 1998. While the literature on the excess volatility of stock prices shows how difficult it is to establish whether such volatility is in a technical sense excessive, the data show remarkable variability of both the volume of flows (see Figures 1 and 2) and of interest rate spreads on emerging market debt (see Figure 3). Second, there appears to be excess contagion in the system—a point that was argued by many during the East Asian crisis, but which became uncontestable after the Russian devaluation and unilateral debt restructuring in August 1998 spread the crisis to Latin America.

It should be noted that in aiming to reduce excess volatility in international capital flows, we are implicitly arguing that at times—for instance, in mid-1997—foreign capital inflows to some emerging market countries have been too large and spreads too low. It is possible that the net effect of the reforms introduced in the next few years will be to raise the average level of spreads, and make foreign borrowing on average more expensive for emerging market borrowers. That will not necessarily be a bad thing if it more accurately reflects the risks of such lending.

Significant progress has been made during the past year in reforming the international financial system. While the measures being implemented and considered will not create a new system, they will noticeably improve the current one. See International Monetary Fund (1999b). One major effort has been to strengthen domestic financial systems. IMF-supported programs in Asia and elsewhere placed a heavy emphasis on bank restructuring and recapitalization. In addition, the IMF, World Bank, other international groups, and

*Views expressed are those of the authors and not necessarily of the IMF.
domestic financial supervisors have stepped up work to develop and implement principles and good practices for sound financial systems, and to improve their capacity to make assessments of financial sector vulnerabilities.

A second major focus has been the strengthening of IMF surveillance, the process whereby the IMF scrutinizes and provides assessments of developments and policies in the world economy and individual member countries. This has involved: (a) greater transparency by the IMF itself, through the publication of IMF staff reports on member country economies, letters of intent and other documents associated with IMF programs, and general policy papers; (b) steps to develop and refine standards of good behavior across a wide front, including data provision (especially with respect to international reserves and external debt), transparency in the conduct of fiscal, monetary and financial policies, and reserve and debt management practices for emerging market economies; and (c) experimentation with ways to improve the assessment of compliance with the various international standards by member countries.5

Rather than attempt to detail the evolving work in these important areas, we will focus in this paper on three other critical issues that are central to the efforts to reduce the frequency and virulence of crises: first, exchange rate regimes, both among major industrial countries and for emerging market economies; second, capital account liberalization, whether and how it should be done; and third, the role of IMF lending in crisis prevention and management.

2. EXCHANGE RATE REGIMES

The right choice of exchange rate regime has been a matter of controversy for well over a century. Against the background of both short-term volatility and medium-term swings in exchange rates among the three central currencies over the past several decades, there have been a number of proposals for stabilizing G-3 exchange rates. These include proposals for target zones (Williamson, 1985, 1994) and a quasi-fixed exchange rate regime among the G-3 to be achieved through monetary policy coordination (McKinnon, 1999). There have also been calls by policymakers in Germany, France, and Japan for new currency arrangements— in Japan in particular, support for such schemes is in part due to concerns that swings in the yen/dollar exchange rate helped cause the East Asian crisis by adversely affecting countries that had pegged to the dollar.6 While recent research suggests that the impact of exchange rate volatility on trade volumes may not be that large (see Eichengreen, 1998), exchange rate swings clearly entail substantial costs for particular sectors of the economy.

There are, however, two fundamental objections to such schemes to stabilize exchange rates among the G-3 currencies. First, they would imply sacrificing the domestic objectives
of monetary policy in the three currency regions to the requirements of external balance. There is no sign that the G-3 will do this, nor has a strong case been made that they should. It does seem that there is an informal and intentionally undefined wide band system in place, under which currency intervention takes place when the major exchange rates appear to be diverging too far from fundamentals.\(^7\) The second basic objection is that these three regions do not satisfy the standard criteria for an optimum currency area.\(^8\)

Turning to other economies—industrial, developing and transition—the optimal exchange rate regime will differ, depending on the specific circumstances of each country. For countries integrated into the international capital markets, the experience of the 1990s provides some clear lessons. The ERM crises of 1992–93 saw the exchange rate pegs of a

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**Figure 2.** Private market financing for emerging markets, 1994Q1 to 1993Q3 disaggregated by region (in billions of US$). (Source: Capital data.)
number of European countries come under massive pressure, leading to the withdrawal of Italy and the United Kingdom from the ERM; devaluations by Spain, Ireland and Portugal; and abandonment of exchange rate pegs in favor of floating by others such as Finland and Sweden. More recently, the crises in Mexico in 1995 and in Thailand, Korea, Indonesia, Russia, and Brazil in 1997–98 all featured the abandonment of pegged exchange rate regimes. Equally striking, Chile, Mexico, Peru, South Africa, and Turkey, with flexible exchange rate regimes, all managed pressures associated with the global financial turbulence in 1997–98 reasonably well.

The lesson here has been known for at least four decades, that the trinity of a monetary policy directed at domestic objectives, international capital mobility, and a pegged exchange rate, is not generally sustainable. In the extreme, this view could be put in the form that a country that seeks to remain integrated into the international capital markets should either float, or else devote its monetary policy to preservation of the peg, for instance, through a currency board. While strong policies and institutions are needed for economic stability no matter the exchange rate system, the demands placed on an economy with a peg are likely to be especially severe, and require not

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Figure 3. Stripped yield spreads for selected Brady bonds, January 3, 1994–November 12, 1999 (in basis points). (Sources: Bloomberg; Salomon Smith Barney; and IMF Staff estimates.)
only a monetary policy directed to defense of the peg, but also a sufficiently strong fiscal policy and robust financial—particularly banking—system that make it possible to deploy monetary policy for that purpose.

Among the emerging market economies, the 30 or so developing and transition economies with access to international capital markets, the interaction between fixed exchange rate regimes and weaknesses in the financial and nonfinancial corporate sectors have been a particular problem in the recent crises. When market sentiment is positive and agents believe that the exchange rate will remain stable due, for example, to progress in stabilization and reform efforts, there is a tendency for domestic banks and firms to borrow heavily abroad. If, however, there are then downward pressures on the exchange rate owing to market concerns about domestic developments or adverse international circumstances (i.e. contagion), the authorities are caught in a very difficult situation, where they are unwilling to raise interest rates to defend the currency because this will hurt weak banks and firms. In such circumstances, market pressures go unchecked and overwhelm the exchange rate peg, causing large depreciations with attendant disruptive consequences.  

This logic has been driving countries open to international capital markets towards one of two polar exchange rate systems, either floating—including managed floating, or strongly pegged, the commitment to the peg being designed to maximize its credibility and reduce the likelihood of a speculative attack.

Once a country has adopted a firm peg, it has given up many of the potential advantages (as well as the potential disadvantages) of an independent monetary policy, but may still be subject to the suspicion of devaluation, and thus have to pay a premium over the interest rates in the country to whose currency it is pegged. This problem has led to arguments for dollarization—the complete abandonment of the national currency—in Argentina and other countries in Latin America.  

This dynamic would tend to lead to the creation of currency blocs and fewer currencies.

Three important caveats should be noted to the bipolar approach. First, for countries with very high inflation, even those open to international capital flows, an exchange rate peg (typically a crawling peg) may well provide the most effective nominal anchor for disinflation—provided the country at an appropriate time effectively exits from the crawling peg, for example by gradually broadening the band around the peg, or moving into a very hard peg. Second, for countries not yet significantly involved with international capital markets, maintaining a pegged exchange rate regime is less demanding. For such countries, there is often much to be said for a pegged exchange rate regime, which can provide a credible and simple anchor for monetary policy. Third, while bipolarity is the underlying tendency, in practice countries are likely to be placed along spectra of the extent of integration into the world capital markets, the degree to which monetary policy pursues domestic goals, and the extent of exchange rate flexibility.

3. CAPITAL ACCOUNT ISSUES

The discussion of the impossible trinity forcefully raises the questions of capital account liberalization and capital controls. Indeed, at the height of the recent crisis, there were many who called for the imposition of capital controls, to enable countries to isolate themselves from the disturbances associated with volatile international capital flows. But virtually unanimously, emerging market policymakers around the world rejected the call to impose capital controls, and reaffirmed their intention of remaining open to international capital flows.

There are two main arguments in favor of capital account liberalization. First, at the simplest analytical level, the case for capital account liberalization is, with a relabeling of the axes, the same as that for free trade. At this simple level, a country that opens its capital account gains access to a potential pool of saving to finance investment opportunities. Similarly, taking risk into account, capital account liberalization makes possible the more efficient international sharing of risks. Further, capital controls are in practice generally a protective device for the domestic financial services industry, which tend to reduce its efficiency.  

Second, capital account liberalization, along with deregulation of domestic financial markets, is an inevitable step on the path of development—all the industrialized countries by now have open capital accounts.

Still, as recent experience has demonstrated, there are risks in capital account liberalization. These risks need to be managed in a way that will reduce the effects of capital-flow related
shocks on the economy. Much of what has to be done is well-known and non-controversial. Sound macroeconomic policies that contain aggregate macroeconomic imbalances—the budget deficit and current account deficit—reduce the danger of an adverse shift in investor sentiment, and also provide more scope for policies to deal with the effects of financial disturbances should they occur. Strengthening the financial sector through supervision and prudential regulation is also essential to ensure proper incentives for private risk management and to reduce the vulnerability of the financial sector and economy more generally to adverse shocks. This implies that capital account liberalization should be phased, or sequenced, with due regard to a country’s macroeconomic situation, the stage of development of its financial markets and institutions, and the impact of existing regulations and controls.12

Controls are often considered as temporary measures to defend a currency in a crisis. We distinguish between controls on inflows and those on outflows. On the side of inflows, while financial innovation has blurred the line between short- and long-term portfolio inflows, there is little case for controls on longer-term inflows, especially those that take the form of foreign direct investment. Such flows have historically been the least volatile of international capital flows,13 and considerable evidence points to their long term economic benefits, including the transfer of technology and of efficient business practices.

Short-term inflows often complicate the conduct of stabilization policy, and because of their volatility, may also pose a threat to macroeconomic stability, especially in a crisis. This is the case for attempting to control such flows, especially where the prudential framework is not sufficiently developed to regulate the risks of foreign borrowing effectively. Such controls are more likely to be efficient to the extent they are market- or price-based, rather than administrative or quantitative in nature. The best known and extensively analyzed case is that of Chile, which imposed a one-year unrenumerated reserve requirement on foreign loans in 1991, but Brazil, Colombia, Malaysia and Thailand have also imposed some form of market-based controls (mainly direct or indirect taxation).

Available evidence on the effectiveness of such controls in these five countries presents a mixed picture.14 If effectiveness is defined as the ability to maintain a wedge between domestic and foreign interest rates while reducing inflows and pressures for exchange rate appreciation, there is some evidence that the controls were partly effective in Malaysia and Thailand in reducing the level of short-term inflows, and in Colombia and possibly Chile in maintaining an interest rate differential and affecting the composition of inflows. Controls in the latter cases, however, were not sufficiently strong to prevent an exchange rate appreciation under the pressure of sustained capital inflows. Controls appear to have been largely ineffective in Brazil. In several countries, financial innovations undermined the effectiveness of the controls. The main conclusion from the analysis seems to be that to be effective, the controls have to be comprehensive, and even then their impact may be short-lived as markets develop ways around the controls.

On the side of outflows, a key question is whether the reimposition of outflow controls can be useful in the midst of a crisis. Ariyoshi, Habermeier and Otter-Robe (forthcoming) seek to shed light on this issue by examining the cases of Malaysia (1998–present), Spain (1992) and Thailand (1997–98), where controls on outflows were reimposed during periods of marked downward pressure on the exchange rate.15 The controls appear to have provided only a limited respite in Spain and Thailand: in Spain, concerns over the damaging effect on legitimate transactions of initially sweeping controls led to a partial relaxation which opened loopholes; in the case of Thailand, the controls were effective only initially as loopholes were soon exploited there as well. In contrast, in Malaysia, the more comprehensive nature of the controls and their strict enforcement by the authorities and commercial banks do seem to have contributed to the containment of speculative pressures. But, the effect of the controls is difficult to assess in the Malaysian case, since they were accompanied by measures to strengthen the domestic financial system, as well as a general return of confidence and capital flows to the region. In addition, the controls hurt foreign direct investment in Malaysia and also raised Malaysia’s risk premium in international markets.16

4. THE ROLE OF IMF LENDING

The scale of IMF lending during the recent crisis led to the charge that the fund was
creating moral hazard in the international system both by bailing out foreign investors in the crisis countries, thereby encouraging reckless private sector lending, and by encouraging irresponsible behavior by policymakers who, knowing they could rely on fund assistance in the event of a crisis, did not take preventative action in time. Indeed, some have argued on these grounds that the international system would be better off without an IMF.

The case for IMF lending is that countries sometimes face severe external financing difficulties at a time when private sector funding is seeking to withdraw, and that markets sometimes overreact. Indeed, the IMF exists as a cooperative agency in part to lend to countries to help them deal with shocks and crises without having to bear the entire brunt of adjustment or, in the language of the IMF’s Articles of Agreement, “without resorting to measures destructive of national or international prosperity.” The need for official lending in crisis situations seems especially clear when international capital flows are both volatile and contagious, as they have been recently.

The often-made argument that the purpose or effect of IMF loans is to bail out foreign creditors is misleading. It ignores the fact that in all recent cases, investors have suffered huge losses in the context of foreign exchange crises. On moral hazard, the argument that the possibility of IMF lending creates policymaker moral hazard seems without merit: policymakers who get into trouble to the extent of needing IMF crisis lending, typically they wait too long to do so. Further, the argument that the moral hazard created by lending to Mexico in 1995 was responsible for the recent crisis, particularly in Asia, does not stand careful examination.

There seems little doubt, however, that moral hazard was a major factor in lending to Russia before the August 1998 collapse, as investors believed that Russia was too big to be allowed to fail. Both on this ground, and as a matter of logic, the moral hazard concern is valid. One way to deal with this moral hazard is to get existing investors to help provide net new financing or to share in the losses associated with crises—that is, to bail in the private sector (by requiring them to provide some of the crisis financing).

This issue has been at the center of official sector concerns in considering how to reform IMF crisis lending. Involving the private sector is necessary not only to ensure that investors assume the risks implied by their loans, thereby helping ensure that yields are correctly priced, but also because the official sector will not have sufficient financing available to do otherwise.

We are at the early stages of the development of a new policy on private sector involvement in the resolution of financial crises. The official sector has promoted modifications of contracts—for instance, by including collective action clauses in bond contracts—in a way that would make their restructuring easier under specified crisis circumstances. Very little has happened in this regard, with borrowers generally being concerned that the inclusion of such clauses would increase spreads. The official sector has also encouraged countries to seek private contingent financing arrangements, such as those of Argentina and Mexico, which enable the country to draw on a private sector line of credit, again under specified circumstances. Although this seems like an overwhelmingly good idea, the lenders may have in place overall country exposure guidelines, which would imply that other emerging market credits could be withdrawn when the contingent lines are drawn down.

It is axiomatic that in the event a crisis does occur, contracts must be honored whenever possible, and that if they cannot be honored, efforts should be made to reach voluntary restructuring agreements on the basis of cooperation between debtors and creditors. But, in situations where a country does not appear to have reasonable prospects for gaining sufficient market financing on a spontaneous or voluntary basis, consideration would need to be given to concerted mechanisms for securing private sector involvement. Several recent cases have involved such mechanisms. In March 1999, as part of its reformulated IMF-supported program, Brazil reached an agreement with its bank creditors that they would maintain exposure to that country, and indeed an adequate roll-over of such credits was achieved. In Ukraine, in late 1998 and 1999 the government negotiated with various major private creditors to roll over a substantial amount of maturing obligations; a significant amount of financing was obtained, but it fell short of what had been targeted. In Romania, which was negotiating with the IMF and had to make debt payments, the government initially approached creditors for a restructuring of the payments.
coming due; it then decided to honor the debt service coming due, partly in light of positive indications by private sector participants that new financing would be available. In the event, attempts to secure the new financing have met with limited success, which has also led to delays in providing the planned amount of financing under the IMF program.

It is uncertain how precisely practices will evolve in this area, but one principle stands out: that it will not be possible in some cases for the official sector to provide sufficient financing to enable a country to meet all its obligations to private creditors. The IMF has also decided that it will be prepared to lend to a country that is undertaking policies to stabilize its economy but is in default to its private creditors, provided the country is making good faith efforts to reach agreement with the creditors. Absent such a policy, a country could in effect be denied official sector financing even in cases where it is trying both to deal with its economic problems and reach agreement with its creditors—a situation that would tilt the balance of the bargaining advantage too far in the direction of the creditors. But such lending should be undertaken only on a case-by-case basis and where early support is judged necessary.

In April 1999, the IMF established the Contingent Credit Line (CCL) facility, as a precautionary line of defense against potential balance-of-payments problems caused by contagion. The CCL would only be available to good performers whose policies are generally sound, who are seeking to meet international standards in relevant areas, whose external debt is well-managed, and who have satisfactory relations with private creditors. The critical innovation with the CCL is that it would enable the IMF for the first time to use its financing in a preventive mode and to help good performers, thereby seeking to prevent crises by providing a financial incentive for countries to pursue appropriate policies and undertake needed reforms ahead of time. The eligibility criteria under the CCL are rather demanding; while the IMF staff's judgement is that they would be met by a number of member countries, so far there have none that have requested use of the facility.

5. CONCLUDING REMARKS

While progress in reforming the international financial system is being made on a broad front, many unsettled issues remain. On exchange rates, the implications of living in a globalized world of open capital accounts are clear, and it is likely that emerging market countries will tend to opt increasingly for a flexible exchange rate regime. But this will not free them of the exacting requirements on domestic policies and institutions that are needed to help ensure macroeconomic stability. Moreover, is quite likely that as time goes by, more countries will join currency blocs and perhaps also monetary unions. While the evidence on capital controls is mixed, those countries that have them in place need to remove them slowly as policies and institutions are strengthened, and in a way that encourages long-term flows, particularly foreign direct investment. In the meantime, countries with weaker institutions may use controls on short-term capital inflows to reduce the volatility of capital flows and to channel them to the long end. The issue of how to involve the private sector in the resolution of financial crises is a critical one, for without private sector involvement, the incentives faced by investors will be inappropriate, and the allocation of capital inefficient. Private sector involvement is also critical to ensuring the efficiency of IMF lending in crisis situations.

The world economy has now emerged from the severe crisis of the 1997–98 and is growing fast. This is the best of times in which to pursue vigorously the lessons of the recent crises. But these are also the circumstances in which the need for reform is likely to be less apparent. At such a time it is even more than usually essential to heed the IMF's unofficial motto: “Complacency must be avoided”.

NOTES

1. For a comprehensive and balanced view, see Eichengreen (1999); see also Council on Foreign Relations (1999) and De Gregorio, Eichengreen, Ito and Wyplosz (1999). A guide to official sector literature on the new architecture is presented in IMF (1999a).
2. In 1998, GDP is estimated to have declined by 13.7% in Indonesia, 5.5% in Korea, 6.8% in Malaysia, 0.5% in the Philippines, and 8.0% in Thailand.

3. After a crisis during which contagion seems important, it is sometimes claimed that there was no contagion, since after all the countries that were struck had major policy or structural weaknesses. Contagion usually infects weaker economies more than stronger ones, but that does not mean that the extent of the crisis in one country is not importantly affected by the extent of crises in related economies. On the existence of contagion, see for example Eichengreen, Rose and Wyplosz (1997).

4. For a review of recent progress, see IMF (1999a).

5. Comprehensive information on efforts in this area may be found on the IMF website on reforms to the international architecture: www.imf.org/external/np/exr/facts/arcguide.htm.


7. See Mussa, Goldstein, Clark, mathieson and Bayoumi (1994) for an extensive treatment of exchange rate issues among the G-3.

8. See Mundell (1961) and Tower and Willett (1976) for a review of the standard theory.

9. See Mussa, Masson, Jadresic and Mauro (forthcoming), for a more detailed discussion of this issue and recent crisis experiences.

10. The disadvantage of this approach is the loss of seigniorage.

11. For a more extensive discussion, see Fischer (1997) and Eichengreen and Mussa (1998).


14. An extensive summary of the research done on the Chilean case is presented in Eichengreen and Mussa (1998), Appendix IV. More recent case studies of the five country experiences are presented in Ariyoshi, Habermeier and Otker-Robe (forthcoming).

15. While the specific design of the controls varied significantly across the three countries, they all mainly targeted the activities of nonresidents by restricting access to domestic currency funds that could be used to speculative against the domestic currency. The controls were most wide-ranging in Malaysia, but in all cases the controls explicitly exempted current international transactions and foreign direct investment.

16. A very detailed review of the Malaysian case is presented in Ariyoshi et al. (forthcoming).


19. See IMF (1999a,b).

20. At a more detailed level, there is also agreement that the role of the IMF in creditor–debtor negotiations should be limited to analyzing the overall financing needs of the adjustment program and assessing the consistency of financing packages with medium-term sustainability, with the negotiation of specific agreements left to the debtors and creditors themselves.

21. See IMF Press Release 99/14 for a detailed description of the CCL.

REFERENCES


