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Expert Paper Three

Financial Stability

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Acronyms and Initials

AECM	aggregate effective currency mismatch
AML	anti–money laundering
ASEAN	Association of South East Asian Nations
BIS	Bank for International Settlements
CAC	collective action clause
CCL	Contingent Credit Line
CFT	combating the financing of terrorism
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSSA	Financial System Stability Assessment
GDP	gross domestic product
GFSR	Global Financial Stability Report
IEO	Independent Evaluation Office
IMF	International Monetary Fund
IMFC	International Monetary Finance Committee
INCSR	International Narcotics Control Strategy Report
NCCTs	Non-Cooperative Countries and Territories
OECD	Organisation for Economic Co-operation and Development
RMB	renminbi (Chinese currency)
ROSC	Reports on the Observance of Standards and Codes
SDR	Special Drawing Right
SDRM	Sovereign Debt Restructuring Mechanism
UN	United Nations
WEO	World Economic Outlook
WTO	World Trade Organization

Preface

Financial markets are highly integrated, and financial instability can spread like a disease—thus, the term "financial contagion." The instability associated with contagion is a global public bad; avoiding it is a global public good. Financial turbulence will never be totally eliminated; the ebb and flow that cause it are intrinsic features of efficient financial markets, which in turn are essential foundations of national and international prosperity. Nevertheless, it is clearly in the international public interest to identify those policies and actions that limit the risks of financial contagion.

The strategies and partnerships the international community has adopted to promote financial stability have evolved over time in line with the challenges it has faced. In many respects, the Great Depression of the 1930s remains the defining event for the international financial system and its governance. Both the economic costs it imposed worldwide and its contribution to the onset of World War II were instrumental in shaping the international financial architecture adopted 60 years ago at the Bretton Woods Conference.

The initial focus of an international system that would promote international financial stability was on avoiding competitive devaluations, enforced through International Monetary Fund (IMF) actions to determine whether a country's exchange rate was appropriate. By the early 1970s, when the Bretton Woods system of fixed exchange rates gave way to a generalized system of floating exchange rates, this scrutiny of devaluations was replaced by surveillance of the underlying macroeconomic and financial policies that affected the level and behaviour of the exchange rate in a market-based environment. Underpinning both (the scrutiny of discrete exchange rate changes in the earlier period and of the policy drivers of market-based exchange rates in the later period), the core pillars remained prudent macroeconomic and financial policies, with low fiscal and balance of payments deficits and rates of monetary expansion and inflation. These pillars survived several subsequent challenges—including the debt crisis of the 1980s and the collapse of the former Soviet Union—and to this day remain necessary ingredients of any strategy (national or international) for financial stability.

Two important shifts characterized the past decade. First is the explosion of private capital flows—especially to developing countries, where private capital flows have dwarfed official flows—including a shift in composition of these flows from syndicated loans to short-term portfolio flows and bond finance. Second is the changing profile and importance of developing countries in the world economy. These shifts contributed greatly to the expansion in global GDP over the decade. But they also revealed vulnerabilities in the international financial system that are still being dealt with. The most visible manifestation of these vulnerabilities is probably the series of emerging market crises that occurred in the 1990s—including those in Mexico (1994); Indonesia, the Republic of Korea, Malaysia and Thailand during the East Asian crisis (1996–98); Russia (1998); and Argentina (2000 and 2003). The estimated GDP losses over the 1990s due to the financial crises amounted to over $400 billion. Other manifestations of the vulnerabilities include the increased use of the international financial system for funding terrorism, organized crime and other criminal and antisocial activities as well as the questioning of the IMF's legitimacy and adequacy to prevent and manage crises.

The Secretariat of the International Task Force on Global Public Goods has commissioned papers to explore in depth these issues. The papers are presented in the next section.

Papers commissioned by the Secretariat of the International Task Force on Global Public Goods

In "Financial Stability" Barry Eichengreen discusses how much progress has been made in preventing and resolving the financial crises that punctuated the 1990s and what issues remain to be addressed. Eichengreen lists four main causes of financial instability: unsustainable macroeconomic policies, fragile financial systems, institutional weaknesses and flaws in the structure of the international financial market. These four broad causes of financial instability reinforce each other and shed useful light on the problem. Eichengreen thus argues that they all suggest an agenda for action both to solve and prevent financial crises, specifically strengthening institutional procedures for formulating fiscal and monetary policies, developing better methodologies for determining the optimal level of reserves and increasing multilateral surveillance. One key proposal is to encourage the World Bank to fund itself on a larger scale in emerging market currencies. Eichengreen believes that this would be important for the creation of a liquid international market in debt securities denominated in those currencies.

Morris Goldstein's "The International Financial Architecture and the Emerging Economies" is more focused than the paper by Eichengreen. Goldstein, while also assessing the challenge posed by the past decade's financial crises, gives priority to three issues, all focused on emerging economies: currency manipulation, currency mismatches and debt sustainability. On currency manipulation, he argues that as emerging economies' share in the global economy increases, how they manage their exchange rates will matter not only to them, but also to the rest of the world. In the next 10 years international norms for exchange rate policy will be no less necessary than those for trade policy. If the currency rules are not interpreted sensibly and enforced, there will be increased conflict and a heightened risk of protectionist response.

Goldstein argues that currency mismatches have been the most prevalent and the most destructive factor in emerging economy financial crises. He proposes a package of reforms, including requiring currency mismatches to be reduced as a condition for IMF loans when the actual or prospective mismatch is deemed too large. On debt sustainability, he supports wider use of collective action clauses to make restructuring more orderly and more timely.

Jim Turnbull's "Financial Stability: A Global Public Good" brings together the contributions by Eichengreen and Goldstein. Building on Goldstein's diagnosis, Turnbull argues that the most significant debt management blunder is the failure to come to terms with the currency mismatch problem caused by an overreliance on foreign currency debt contracts. To address this problem, Turnbull develops Eichengreen's idea for international financial institutions to borrow and lend in developing country currencies. Turnbull also advocates reconstituting the Financial Stability Forum as a centralized monitoring and reporting agency with full powers to recommend multilateral intervention in countries that have a deteriorating currency mismatch.

David Peretz's "Assessment of the IMF as the Principal Institution for Promoting the Global Public Good of Financial Stability" looks at the IMF's mission in greater detail. He analyses how and how well the IMF is managing financial stability. Peretz argues that the IMF has many strengths: professionalism, management, flexibility, speed of response, governance and legitimacy. But he also identifies gaps in current arrangements and issues that require attention if the IMF is to retain those strengths and adapt to a new role and changing expectations. Peretz makes several proposals for the short and long term. In the short term, he suggests that the IMF pay more attention to risks of currency mismatches and debt sustainability in developing countries. In the long term, he recommends that voting shares be realigned to better reflect current economic realities. He suggests aligning voting shares with GDP calculated on a Purchasing Power Parity basis, perhaps also giving some weight to a number of basic votes for each member. On technical assistance and capacity building, Peretz argues that the IMF should focus more on identifying needs for technical assistance and capacity building while relying on organizations that have a comparative advantage managing and providing such assistance, such as the World Bank, for actual delivery.

Ted Truman's "Anti–Money Laundering as a Global Public Good" focuses on another aspect of globalization and the associated increase in the volume and speed of international capital flows: the inadvertent assistance provided to criminal elements for the cross-border financing of illegal and terrorist activities (money laundering). Truman analyses the global public good aspect of the global anti–money laundering (AML) regime. He presents its definition, background, and history and, after assessing its strengths and weaknesses, proposes six improvements: developing quid pro quos to achieve greater international cooperation, emphasizing corruption, articulating global AML strategies, providing financial as well as technical assistance, preparing a periodic global report on money laundering, and pursuing a cooperative research strategy. Truman also makes a qualitative cost-benefit evaluation of some recommendations.

Financial Stability

1 Chapter

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Financial stability is a global public good because of the tendency for financial turbulence to spill across borders. As with all public goods, there is a free-rider problem and a danger of underprovision. This tendency towards underprovision has manifested itself, most recently, in the series of contagious emerging-market financial crises that punctuated the 1990s. In turn this has led to a major effort on the part of governments and multilateral organizations to better organize and coordinate efforts to prevent and resolve financial crises.

This study describes the nature of these financial problems and recent efforts to address them, distinguishing crisis prevention and crisis resolution. It then turns to the unfinished agenda. On crisis prevention, it emphasizes the need to strengthen institutional procedures for formulating fiscal and monetary policies; to encourage emerging markets to pursue alternatives to formal and covert exchange-rates pegs; to develop better methodologies for determining the optimal level of reserves; to strengthen multilateral surveillance; to further improve prudential supervision and regulation; to enhance shareholder and creditor rights and the transparency of financial markets as a way of improving the governance of corporate financial affairs; to strengthen financial market infrastructure; and to amend the Basel capital standards to allow capital requirements to fall in periods when there is a flight to quality and rise in periods when international financial markets are unusually liquid as a way of limiting the procyclicality of financial flows to emerging markets.

In terms of crisis resolution, it recommends establishing an Enhanced Monitoring Facility in the International Monetary Fund with the ability to more rapidly disburse significant chunks of financial assistance to countries with strong policies and pressing balance of payments needs; encouraging the World Bank to experiment on a limited basis with funding itself in emerging market currencies *as a first step towards creating a liquid international market in debt securities denominated in those currencies; and considering whether regulatory action is needed to encourage sub-investment-grade borrowers to issue bonds with collective action clauses.*

Financial stability is a global public good because of the tendency for financial turbulence to spill across borders (Wyplosz 1999). To the extent that the consequences are external to the country or countries in which the turbulence originates, there is a corresponding tendency to under-invest in its provision. This situation of underinvestment (due to non-rivalness in consumption and non-excludability of access to the benefits) is the hallmark of a public good.

The context here is straightforward. Recent disruptive financial crises in Mexico in 1994, Asia in 1997, Turkey in 1999 and Argentina in 2001 have imposed significant costs on the originating economies and often caused serious corollary damage in neighbouring countries. The result has been a major effort on the part of governments and multilateral organizations to more effectively prevent and resolve financial crises. This study discusses how much progress has been made towards achieving this goal and what issues remain to be addressed.

Causes of financial instability

Any effort to come to grips with financial instability should start from a statement of the causes of the problem. Here, one may distinguish four categories of explanation.

Unsustainable macroeconomic policies

This is the focus of early crisis models starting with Krugman (1979).[1] Countries experience currency crises, in these models, because they run inconsistent and unsustainable policies. In the classic case, monetary and fiscal policies are too expansionary to remain consistent with the currency peg. Countries experience banking crises because governments treat banks as a captive market for the public debt issues that they must place in order to finance budget deficits (Serven and Perry 2003). Macroeconomic imbalances are the fundamental cause of crises, in this view, although the proximate triggers may be contagion effects or imprudently low levels of international reserves.

This leaves open the question of why countries are prone to unsustainable and contradictory macroeconomic policies in the first place. Efforts to answer this question have focused increasingly on weaknesses in policy-making processes (see, for example, Poterba and von Hagen 1999). The central bank may lack a clear mandate and adequate independence. Fiscal institutions may allow spending ministries and provinces to spend now and appeal later to the central government for the necessary finance, creating common-pool problems for the fisc. The instability of the political system may encourage leaders to spend and borrow freely without worrying about the intertemporal consistency of their fiscal plans, in order to increase their immediate prospects of staying in power. These theories thus point to the need for stronger policy-making processes as a fundamental prerequisite for financial stability.

Fragile financial systems

A number of recent financial crises were not obviously rooted in macroeconomic imbalances. In the Asian crisis, for example, macroeconomic imbalances were not prominent.[2] At the same time, financial weaknesses seemed to play a larger role than in previous crises. In countries such as South Korea, the banks' dependence on short-term debt rendered them vulnerable to investor panic. More generally, balance-sheet vulnerabilities put banks and non-bank financial institutions (finance companies, for example) at risk when confidence ebbed and footloose capital began haemorrhaging out of the country.

Recent work (for example, Goldstein and Turner 2003; see also Goldstein's "The International Financial Architecture and the Emerging Economies" in this volume) has emphasized currency mismatches in the financial system as a key source of vulnerability. When banks have assets in local currency but liabilities in dollars, fears of a crisis that cause the exchange rate to weaken can become self-fulfilling, since at the now weaker exchange rate assets are no longer sufficient to service or redeem their liabilities. Even if banks lend in dollars, their clients, who have incomes in local currency but debts in dollars, will be thrust into bankruptcy if the local currency declines, bringing the financial system crashing down.

This view consequently emphasizes vigorous prudential regulation and supervision as the key to preventing financial instability. Governments should distance themselves from the banking system, resisting the temptation to use banks as instruments of development policy. Responsibility for supervision and regulation should be placed with an independent central bank or regulatory agency. Special attention should be paid to limiting currency mismatches, not just on bank balance sheets but on the balance sheets of corporations and other borrowers as well.

Institutional weaknesses

The preceding observations, motivated by the Asian crisis, raise the question of why banks and borrowers do not better manage these vulnerabilities. This question has given rise to a literature emphasizing weaknesses in domestic governance structures as the cause of financial instability. Contributors emphasize that bank managers and corporate CEOs who are inadequately accountable to shareholders may have inadequate incentive to prudently manage financial risks. Short-sighted governments, for their part, may be reluctant to distance themselves from financial institutions and may deny regulatory agencies the autonomy needed for their effective operation. Macroeconomic policy may also play a compounding role, insofar as policies limiting exchange-rate flexibility mislead managers into thinking that the need to hedge currency exposures is minimal.

In this view, weak corporate and public sector governance conducive to excessive private sector risk taking is at the root of financial crises. The corresponding solution is to strengthen shareholder and creditor rights, improve corporate governance and financial transparency and place clear and credible limits on the official safety net protecting financial institutions and markets.

Flaws in the structure of international financial markets

A final view links financial instability to the structure and operation of the international financial system.[3] Proponents of this view emphasize the pervasiveness of asymmetric information, which encourages herding by investors and gives rise to sudden stops and capital flow reversals that can cause crises independently of conditions in the afflicted economies (see Devenow and Welch 1996).

A related interpretation harks back to explanations for financial crises emphasizing weaknesses in financial systems. It suggests that developing countries are vulnerable to crises because of the reluctance of international investors to hold debt securities denominated in emerging-market currencies. Inevitably, then, emerging markets that borrow abroad will have currency mismatches on their balance sheets. Limiting financial instability therefore requires an international initiative to enhance the ability of emerging markets to borrow in their own currency or to eliminate the currency-mismatch problem in other ways.[4]

While it is tempting to blame weak domestic policies and institutions for the difficulty that emerging markets face when attempting to borrow abroad in their own currencies, the fact is that even countries with strong policies and institutions (Chile is a good example) find it difficult to borrow abroad in their own currencies. Empirically, the one characteristic that is robustly associated with the ability to borrow abroad in one's own currency is country size (large countries can, small countries can't).

This encourages the view that the difficulty that emerging markets face when attempting to borrow abroad in their own currencies reflects, at least in part, factors beyond their own control—specifically, a combination of first-mover advantages and network externalities.[5] These observations are related to the literature on the determinants of key currency status (Kiyotaki, Matsuyama and Matsui 1992), which explains the dominance of a small number of currencies in international markets as a function of network externalities and transaction costs. This literature shows how transaction costs in a world of heterogeneous economies can explain both the bias towards a small handful of currencies and why countries that are early to industrialize or attain financial-centre status are most favourably positioned to attain key-currency status (and to retain it over time). It suggests that the global portfolio is concentrated in a very few currencies for reasons largely beyond the control of the excluded countries.

These four broad classes of explanation for financial instability are not incompatible rivals. They all shed useful light on the problem. And, in turn, they all suggest an agenda for action.

Better crisis prevention

Financial instability will never be eliminated, since volatility is an intrinsic feature of financial markets. But it would be desirable if the incidence of disruptive and costly financial crises was reduced. Initiatives are therefore needed to address each of the four causes of financial stability enumerated above.

Limiting macroeconomic sources of financial vulnerability

The problem of macroeconomic imbalances can be addressed at both the national and international levels. Nationally, countries must continue strengthening their policy-making processes, enhancing fiscal transparency, streamlining budgeting procedures, and buttressing the independence of central banks. Internationally, the International Monetary Fund (IMF) has promulgated codes for the conduct of monetary and fiscal policies and sought to define sustainable levels of debt. The IMF, the Organisation for Economic Co-operation and Development (OECD), and other international groupings conduct multilateral surveillance of macroeconomic policies, seeking to provide early warnings of potentially dangerous imbalances, together with peer pressure for corrective action. While progress in reducing monetary and fiscal imbalances has varied across countries, there are some reassuring signs. One summary measure of improvements in monetary and fiscal balance is the decline in global inflation from 30 percent to 4 percent a year in the last 10 years (Rogoff 2003).

Another sign of progress in reducing macroeconomic sources of financial vulnerability is the rationalization of exchange-rate policies and the accumulation of international reserves. A growing number of countries have abandoned formal exchange-rate pegs, which are a source of vulnerability in a world of liquid international financial markets.

At the same time many emerging markets continue to operate heavily managed floats, which in some cases approach the status of covert pegs. They are reluctant to allow their exchange rates to appreciate even in situations of strong economic growth and balance-of-payments surplus. This behaviour has implications for both the global adjustment process (which currently takes the form of intense pressure on the euro as the dollar adjusts downward in response to the US external deficit) and for emerging markets themselves (which presumably suffer costs, in the form distorted relative prices and resource misallocation, from policies that prevent emerging-market currencies from adjusting upward). How emerging markets can be encouraged to move to greater de facto flexibility is becoming an increasingly pressing problem for the international financial community, as Goldstein notes in "The International Financial Architecture and the Emerging Economies" in this volume. Another way of posing the same question is to ask whether emerging markets are paying excessively for insurance against capital-flow reversals and sharp exchange-rate shifts, by accumulating large amounts of low-yielding reserves.[6]

As noted above, recent research has pointed to the importance of strong policy-making institutions for sound and stable macroeconomic policies. This highlights the importance of encouraging countries to make their central banks economically and politically independent, where this is not already the case. The conduct of monetary policy should be made more transparent. Fiscal policy-making procedures should be made more hierarchical, with more agenda-setting power for the finance minister or prime minister, and where this is not possible consideration should be given to the use of numerical spending or deficit caps. Emerging markets have moved a considerable distance in the direction of central-bank independence, but less progress has been made in rationalizing budgetary institutions and procedures (see, for example, Alesina and others 1999).

Multilateral surveillance should be made more forthright by an unconditional commitment on the part of the members of the international financial institutions to publish the results of surveillance exercises. The multilaterals, for their part, need to make further progress in estimating prudent levels of debt for countries in different circumstances, including the particular circumstances of developing countries with volatile terms of trade and relatively narrow tax bases.

Limiting financial vulnerabilities

Developing countries have made considerable progress in strengthening their financial systems over the last ten years, but more remains to be done. Argentina's crisis, where the presence of affiliates of foreign financial institutions turned out to be no help, served as a reminder that there are no effective shortcuts—like banking-system internationalization—to this hard slog.

Argentina's crisis also pointed to financial vulnerabilities created by aggregate currency mismatches. Prudential regulations requiring banks to match the currency composition of their assets and liabilities may not be enough if the ultimate borrowers (domestic corporations, in particular) end up as a result with mismatched dollar debts and peso-denominated incomes on their balance sheets. Goldstein and Turner (2003) offer a range of recommendations for addressing these risks, including prudential measures that would force banks to tighten credit limits on foreign-currency–denominated loans to customers without foreign-currency revenues, as well as measures that would strengthen corporate governance and therefore encourage borrowers to more prudently manage currency risk and greater exchange-rate flexibility so that banks and corporations better appreciate the need to hedge, to capital controls that would limit recourse to foreign funding in countries where the effectiveness of the aforementioned measures is dubious.

At the global level, the Mexican and Asian crises led to the promulgation of financial standards and codes defining acceptable practice in these areas. The unfinished agenda here includes conclusion of the revised Basel Capital Accord (Basel II) on capital-adequacy standards.

Strengthening the financial infrastructure

There have been both global and regional efforts to encourage the adoption of internationally recognized accounting standards, the practice of comprehensive financial disclosure and the construction of more efficient and predictable payment and settlement systems. The IMF and the Financial Stability Forum have promulgated international standards and recommendations for action on these issues.[7]

Regional groupings, notably in Asia, have sought to reinforce these global efforts. The 17 Asian governments participating in the Asia Cooperation Dialogue have set up a Working Group on Financial Cooperation to establish guidelines for the development of Asian bond markets. Finance ministers of Asia-Pacific Economic Cooperation members are seeking to agree on a comprehensive approach to developing sound and sustainable regional financial markets, including credit guarantee markets and markets in a variety of new products (bonds denominated in a basket of Asian currencies being the most attractive candidate). ASEAN+3 has established a Study Group on Capital Market Development and Cooperation under the leadership of Thailand, Japan, Korea and Singapore. The Executives' Meeting of East Asia Pacific Central Banks has established a working group on payment systems and focused its discussions on the development of financial-market infrastructure.

Addressing weaknesses in the international financial system

Those who argue that international market forces can place financial stability at risk even in countries with strong economic and financial fundamentals point to the need for a precautionary IMF facility to protect against self-fulfilling crises. With the expiration of the IMF's

Contingent Credit Line (CCL), this gap has grown more glaring. Three options that have been suggested for extending assistance for such countries without also imposing an onerous prequalification requirement (like that which proved so debilitating to the CCL) include: simply stating that the IMF has considerable flexibility under its existing facilities to provide financial support for countries with strong policies that are facing balance-of-payments pressures; modifying precautionary arrangements in order to provide more up-front financial assistance for countries that negotiate such arrangements; and creating a new instrument, which might be tentatively called Enhanced Monitoring Policy, that would combine more intensive monitoring with more immediate financial assistance than is typically available under precautionary arrangements.[8]

One reason there has been reluctance to move in this direction is the lack of full agreement on the precise circumstances under which the IMF should provide financial assistance to a crisis country. Analytic treatments continue to focus on the distinction between insolvency and illiquidity (see, for example, Roubini and Setser 2004), notwithstanding the difficulties of applying these concepts to countries as opposed to households and firms. The IMF should support a country in cases of illiquidity, the argument goes, but countries with solvency problems should instead be left to restructure their debts.[9] It should be both tougher on countries whose debt sustainability is questionable and easier on countries whose debt sustainability is not an issue. Thus, while policy-makers prefer the terminology of sustainable versus unsustainable debts to solvency versus insolvency, the underlying concepts are the same.

Despite efforts to refine the concept of debt sustainability, an adequate operational definition is still lacking. The IMF's September 2003 *World Economic Outlook* offered the value judgement of the IMF's own staff that debt levels in many emerging markets are "dangerously high," but without providing a rigorous framework for gauging debt sustainability.

Elsewhere, the IMF has suggested estimating a fiscal-reaction function, analogous to a Taylor rule for monetary policy, and checking whether the elasticity of the primary balance with respect to the debt/GDP ratio is sufficient to guarantee a non-explosive debt profile. It has also suggested comparing the actual debt with a benchmark level equal to the present value of future primary surpluses computed under conservative assumptions.[10] Still other authors have suggested value-at-risk approaches to debt sustainability (see Garcia and Rigoban 2003). But there is no consensus on which if any of these approaches is reliable and which if any of them provides an adequate operational guide for IMF lending policy. So long as this is the case, the much-needed rationalization of IMF lending facilities is unlikely to occur.

There is also growing recognition that the international system lacks mechanisms for damping the capital-flow cycles that consign emerging markets to alternating feasts and famines—which either flood them with liquidity, eroding the incentive for policy discipline, or starve them of capital, placing economic, financial and political stability at risk. There has been little progress in designing a system of "locks and levies" at the global level that might help to moderate these fluctuations. Indeed, the revised Basel Capital Accord (Basel II), which will make capital requirements on loans to emerging markets more sensitive to credit ratings, threatens to exacerbate the problem of capital-flow procyclicality.

Finally, there has been little attention in policy circles to the issue of how the structure of the international financial system—and the limited appetite of international investors for debt securities denominated in emerging-market currencies, in particular—may make it more difficult for emerging markets to borrow abroad in their own currencies, confronting them with the Hobson's choice of not borrowing or else saddling themselves with a dangerous currency mismatch.[11] Eichengreen and Hausmann (forthcoming) have suggested that the World Bank and other international financial institutions could help to create the necessary demand by issuing debt securities denominated in an inflation-indexed basket of currencies of emerging and developing countries.[12]

Better crisis resolution

Reforms to more smoothly resolve crises are necessary to minimize their social and human costs. In addition, limiting the duration and severity of financial dislocations will limit the pressure on the IMF to indiscriminately assist potential crisis countries; it will thereby address worries about moral hazard due to IMF rescue packages.

For the last several years, the debate over this issue has centred on the merits of the so-called contractual and statutory approaches and specifically on whether to encourage the more widespread use of collective-action clauses in loan agreements or instead to create a Sovereign Debt Restructuring Mechanism (SDRM). At the spring 2003 meetings of the IMF and World Bank, it was acknowledged that there did not exist sufficient support to push ahead with the SDRM. Market participants remain deeply sceptical, if not outright hostile, worrying that even the IMF's revised proposal ("SDRM-Lite") would entail a significant erosion of investor rights. At a minimum, proceeding with the statutory approach would have created considerable uncertainty that might have been demoralizing to international capital markets and significantly depressed the volume of international capital flows. By implication, even more ambitious statutory approaches, such as attempting to create a full-fledged international bankruptcy court, will remain non-starters for the foreseeable future.

In contrast, the contractual approach has made headway with the issuance in New York of sovereign bonds with collective action clauses (CACs) by Mexico, South Korea, South Africa, Brazil, and a number of smaller countries. There remain two questions about the efficacy of this approach. First, these countries issued bonds with CACs in New York during a period when market liquidity was abundant. It is not clear that investors will be as eager to take up such issues when market conditions are less favourable.[13] Some observers worry that only countries with investment-grade credit ratings (or close to investment-grade ratings) will be able to avoid paying a significant spread premium when issuing such bonds. If so, then there is a danger that these provisions will be included only in the bonds of those countries that need them least. There may then be a case for using regulation or pecuniary subsidies to encourage their more widespread utilization (Roubini and Setser, forthcoming).

Second, there is the question of whether these limited contractual innovations will suffice to significantly smooth the process of sovereign debt restructuring.[14] Typically CACs include provisions to discourage disruptive litigation by rogue creditors; the power to litigate is vested with the trustee, acting on the instruction of creditors holding a specified fraction of the principal, who is required to distribute all funds recovered in proportion to the principal amount. However, as an increasing number of relatively small issues with CACs work their way into the market, the possibility grows stronger that individual investors will be able to accumulate a sufficient block of holdings to undertake opportunistic litigation anyway. If so, the case for a statutory standstill mechanism would be strengthened.

There also remains the possibility that creditors not enamoured of CACs will substitute away from bonds in favour of other debt instruments (bank loans, trade credits). In principle there is no barrier to extending the coverage of collective action provisions to such instruments, although doing so may require legal or regulatory intervention.

Finally, some worry that adding CACs to individual covenants does nothing to address the problems of coordinating the holders of separate bond issues. There is some evidence that this "aggregation problem" is of concern to the markets.[15] There have been various proposals for addressing it, including J.P. Morgan's two-step scheme, Uruguay's experiment with super-CACs and the creation of standing committees of bondholders. Their effectiveness remains an open question.

Only time and experience will shed light on the gravity of these issues.[16] If they do suggest significant problems with the contractual approach, it may then be necessary to revisit the statutory alternative.

Recommendations

Even a discussion as short as this one suggests an extensive agenda for action. A limited list of priority recommendations would include the following.

For national governments and the multilaterals working with them

- *Strengthen institutional procedures for formulating fiscal and monetary policies at the national level.* This is first and foremost a task for the governments of the emerging markets themselves. But, in addition, further work on international standards for the design of the relevant institutions and procedures could usefully contribute to this process. As Goldstein notes in "The International Financial Architecture and the Emerging Economies" in this volume, creating adequate incentives for adoption is the most obvious place where this effort has fallen short. One approach to this problem is for the IMF, the World Bank and the Financial Stability Forum to work with the rating agencies to encourage the latter to highlight code compliance in their rating decisions. Indeed, this could be the official community's general approach to dealing with the problematic compliance aspect of its various initiatives related to standards and codes.
- *Encourage emerging markets to pursue alternatives to formal and covert exchange-rate pegs.* These alternatives could be along the lines of open-economy inflation targeting (Eichengreen 2002) and managed floating

plus (Goldstein 2002). Again, this is foremost a task for the individual countries concerned. But it also has implications for the IMF, which will need to be more forthright about the need for greater exchange-rate flexibility and should no longer defer to the notion that any regime is fine so long as it is sustainable. The IMF could also renew its practice from the 1980s of constituting special missions to address particularly pressing exchange-rate problems in individual countries.

- *Develop better methodologies for determining the optimal level of reserves for countries under different macroeconomic and financial circumstances.* After the balance-of-payments crises of the 1990s there is a tendency to think that no level of reserves is too high. An important step in this area would be for governments and central banks to get a better quantitative handle on the costs (in terms of the efficiency of resource allocation) of excessive reserves. A number of them are already actively researching this topic. In addition, this is a place where more research effort by the IMF is warranted. The IMF could then use the results to more forcefully warn countries prone to accumulating excessive reserves.
- *Further strengthen prudential supervision and regulation.* Follow Goldstein and Turner by making the currency-mismatch problem a focus of supervisory efforts. Once more, this is first a challenge that must be taken up by national regulators. But the IMF can help by publishing data on currency mismatches and making them a focus both of its surveillance exercises and country programmes.[17]
- *Strengthen multilateral surveillance by increasing the transparency of the process.* Transparency could be increased, for example, by no longer leaving to the member country the ultimate decision of whether surveillance-related documents are published. Governments involved in regional surveillance exercises like the European Union and ASEAN have a particular need to show that they are prepared to provide blunt assessments of the adequacy of national policies.
- *Strengthen shareholder and creditor rights and the transparency of financial markets.* Such measures would improve the governance of corporate financial affairs. Both national initiatives and international standards promulgated by the multilaterals and self-organizing private-sector bodies can assist in this task.
- *Strengthen financial-market infrastructure by developing more efficient payment and settlement systems.* Once more, both national initiatives and international standard setting, in conjunction with peer pressure, have a role to play in this process.

For the multilaterals and G-10 governments

- *Establish an Enhanced Monitoring Facility (EMF) in the IMF with the ability to more rapidly disburse significant chunks of financial assistance to countries with impeccably strong policies but pressing balance-of-payments needs.* A challenge here will be to reconcile, on one hand, an EMF that provides more extensive support for countries with strong policies and, on the other hand, reforms of existing IMF facilities for countries with weak policies that strengthened access limits (as recommended by Goldstein in "The International Financial Architecture and the Emerging Economies in this volume).
- *Explore an amendment to the Basel capital standards to allow capital requirements to change with market conditions.* Specifically, consider allowing capital requirements to fall in periods when there is a flight to quality and rise in periods when international financial markets are unusually liquid, as a way of limiting the procyclicality of financial flows to emerging markets.
- *Encourage the World Bank to experiment on a limited basis with funding itself in emerging-market currencies.* Such a measure would be a first step towards creating a liquid international market in debt securities denominated in those currencies.
- *Consider whether regulatory action is needed to encourage sub-investment-grade borrowers to issue bonds with collective action clauses.* And if the more widespread use of CACs does not significantly smooth the process of sovereign debt restructuring, revisit the case for a statutory sovereign debt restructuring mechanism.

Notes

1. Appropriately so, since macroeconomic imbalances that developed in the 1970s were widely implicated in the crises of the early 1980s. Macroeconomic factors continue to be the focus of authoritative analyses of some recent crises, such as Mussa's (2003) treatment of the recent Argentine case.
2. The case of Thailand notwithstanding to the contrary.
3. This interpretation has roots in Keynes (1933) and Nurkse (1944), who generalized from the Great Depression about the destructive effects of destabilizing international speculation. A famous restatement of this view is the speech of then Malaysian Prime Minister Mahathir at

the IMF-World Bank meetings in Hong Kong in 1998, in which he blamed hedge funds and other "international speculators" for destabilizing fundamentally stable emerging-market economies. For the academic version of this argument see de Brouwer (2001).

4. Contributions to this literature, starting with Eichengreen and Hausmann (1999), observe that the global portfolio is concentrated in the currencies of a few large countries and international financial centres. Of the nearly $5.8 trillion in outstanding securities placed internationally in the period 1999–2001, $5.6 trillion was issued in five major currencies: the US dollar, the euro, the yen, the pound sterling and the Swiss franc. While residents of these countries issued $4.5 trillion dollars of debt over this period, the remaining $1.1 trillion of debt denominated in their currencies was issued by residents of other countries and by international organizations. Since these other countries and international organizations issued a total of $1.3 trillion dollars of debt, it follows that they issued the vast majority of it in foreign currency.

5. Hence the label "original sin" sometimes given to this phenomenon.

6. Probably the most useful empirical study of this question to date is Aizenman and Marion (2002).

7. Initiatives in this area include the Financial Sector Assessment Program and Reviews of Standards and Codes of the IMF and World Bank.

8. But less assistance than would have been available under the CCL.

9. Although the IMF may still wish to provide critical working capital in the interim, by engaging in limited lending into arrears to countries that are making a good-faith effort to negotiate with their creditors.

10. On these and other approaches, see IMF (2003b).

11. It is not necessary to insist that country policies, either current or past, have nothing to do with this problem, but only to observe that it may be exacerbated by the limited appetite of international investors for debt securities denominated in emerging-market currencies, in order to believe that the international system plays a role in the problem of "original sin."

12. Goldstein's "The International Financial Architecture and the Emerging Economies" in this volume dismisses the idea of issuing securities denominated in a basket of emerging market securities as less than realistic and straightforward. I disagree, partly because the basket is not the key element of this proposal; rather having the World Bank fund itself in emerging-market currencies and lending to those members in those currencies (with indexation for inflation) is what's key. In fact, as Eichengreen and Hausmann (2003) show, domestic-currency-inflation-

indexed bonds and GDP-indexed bonds, Goldstein's preferred alternative, have much in common with one another.

13. Eichengreen, Kletzer and Mody (2003) provide evidence that the point at which emerging markets have to pay a premium in order to issue bonds with CACs shifts significantly with overall market conditions.

14. There is some dispute over the pervasiveness of the danger of disruptive litigation by rogue creditors. Experience since Argentina's default in December 2001 suggests that it cannot be ruled out.

15. Eichengreen and Mody (2003) show that countries with a larger number of separate sovereign bond issues in the market are required to pay higher spreads, presumably reflecting the greater complexity of any subsequent debt restructuring.

16. In particular, Argentina's debt restructuring will be telling.

17. In addition, "second generation reforms" in this area should move beyond recommending specific policy measures and concentrate in addition on buttressing the independence of regulatory agencies.

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The International Financial Architecture and the Emerging Economies

Chapter 2

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In assessing the unfinished reform agenda for the international financial architecture, three issues, all focused on emerging economies, should receive priority: currency manipulation, currency mismatches and debt sustainability. There are, of course, a host of other challenges facing the international financial system—and issues related to the institutions, the rules and sanctions and the resources associated with those challenges.[1] *This contribution explains why currency manipulation, currency mismatches and debt sustainability merit particular attention and offers several proposals for reform in each area.*

Currency manipulation

Almost all the prominent emerging-market currency crises of the past decade involved the collapse of overvalued, publicly announced exchange rate targets. In some of those crises (Mexico, the Russian Federation, Brazil, Turkey and Argentina), the degree of overvaluation was considerable; in some others (several of the Asian financial-crisis economies), it was arguably more modest. Still, the problem was to convince emerging economies to devalue before the loss in competitiveness and the size of currency and maturity mismatches became so noticeable that the market forced a change in regime via a currency crisis.

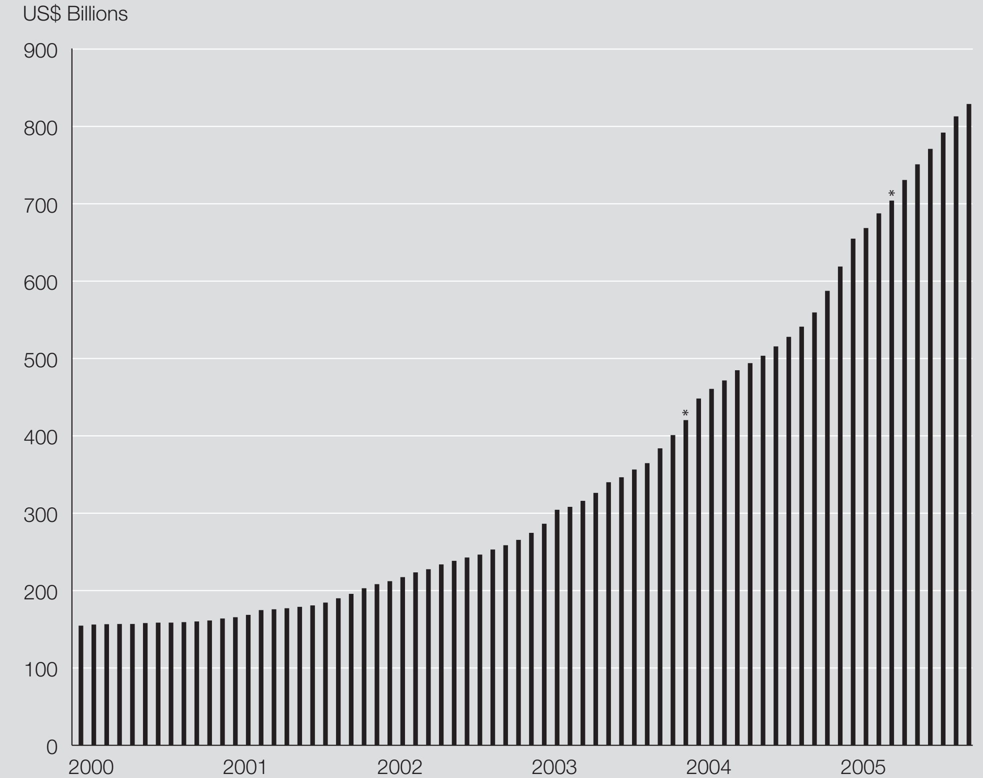
During the coming decade, the problem may be different; indeed, it will be closer to the "competitive devaluation" problem experienced during the 1920s and 1930s. The emerging economies of Asia now hold over 40% of global reserves.[2] Some of them (especially China) also face formidable employment challenges. One response is to use prolonged, large-scale exchange market intervention to hold down the value of the exchange rate, so that the undervaluation is substantial enough to generate a surplus in the balance of payments large enough to assist the country's export, growth and employment objectives. The rub of course is that such currency manipulation runs counter to agreed international rules of the game, that it can thwart external payments adjustment, that it can contribute to domestic financial instability and that it is apt (eventually) to provoke retaliatory trade measures from other countries. These points are well illustrated by the ongoing debate about the appropriate exchange rate and regime for the Chinese currency, the renminbi (RMB).

Under the charter of the International Monetary Fund (IMF), each member country agrees to avoid manipulating exchange rates to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other countries. The IMF is charged with overseeing the compliance of each country with these obligations.

Countries can "fix," "float" or adopt a wide variety of intermediate currency regimes. Countries are also permitted to intervene in exchange markets—particularly when intervention is necessary to counter disorderly market conditions. But countries can run afoul of IMF guidelines on appropriate exchange rate policy if they engage in protracted, large-scale intervention in one direction in exchange markets. This type of intervention raises a red flag because it may indicate that the country is seeking to maintain the "wrong" exchange rate.[3] In the case of the Chinese RMB, there has been prolonged, large-scale, one-way exchange market intervention for the better part of three years (see figure 2.1).

Just because a country maintains a fixed nominal exchange rate over an extended period of time does not mean that it cannot be manipulating its exchange rate.[4] What one wants to look at is how a country's real, trade-weighted exchange rate has been behaving against the backdrop of its overall balance-of-payments position. Until the small (2%) revaluation of the RMB announced on July 21, 2005, China's nominal exchange rate had been fixed at roughly 8.3 RMB per US dollar for more than eight years. During most of that period, the RMB followed the US dollar up against most currencies. But during 2002–04 the US dollar was falling on a real, trade-weighted basis, and the real, trade-weighted value of the RMB fell along with it—at a time when China was running large surpluses on both the current and capital account in its balance of payments, was experiencing huge increases in international reserves and was facing a serious overheating of its economy.[5]

Figure 2.1 **China's Foreign Exchange Reserves, 2000–2005**



*After 12/2003, foreign exchange figures are adjusted to reflect $45bn transfer to BOC, CCB.
*After 4/2005, foreign exchange figures are adjusted to reflect $15bn transfer to ICBC.

A current account surplus and large reserve accumulation call for an appreciating real exchange rate—not a depreciating one—and lack of movement of the nominal exchange rate in such circumstances hinders effective balance-of-payments adjustment; that is, it smacks of currency manipulation.

In 2005 China's external imbalance has gotten much larger still—with the trade balance for the first half of 2005 larger than that for all of 2004 and with some respected China analysts—such as Jon Anderson (2005) of UBS—projecting an overall current account surplus in the range of 8%–10% of GDP; China's reserve accumulation is again likely to be very large—at least 10% of GDP.[6] True, the real effective exchange rate of the RMB has been appreciating in 2005 but this is misleading because it reflects real, trade-weighted appreciation of the US dollar and real trade-weighted depreciations of some other major currencies.[7] Since the US dollar needs to depreciate in real terms over the medium term (see discussion below), and since other major currencies need to appreciate against the dollar, it is likely that the 2005 real appreciation of the RMB will be reversed (in 2006–07), unless there is a substantial appreciation of the RMB vis-à-vis the dollar. Note also that for the February 2002 to October 2005 period as a whole, the RMB has depreciated in real, trade-weighted terms.[8]

Currency manipulation can likewise handicap the international adjustment process. The US current account deficit—now running at about 6%–6.5% of GDP and threatening to go higher (see Cline 2005)—is much too large. A sustainable deficit would be about half that size.[9] But to bring that about a significant reduction of the US external imbalance while simultaneously maintaining healthy global economic growth requires, among other measures, a further depreciation in the real, trade-weighted dollar from its current level—on the order of 15%–25%. Emerging Asia plus Japan have roughly a 40% in the trade-weighted dollar index. While most market-determined exchange rates (for example, the euro, the Canadian dollar, the Australian dollar, and the like) have experienced strong (real, effective) appreciations during the first wave of dollar depreciations (beginning in February 2002), the Asian currencies—with the notable exceptions of the Korean won and Singapore dollar—have not.

The problem is that if the Asian currencies do not lead the way in the needed second wave of dollar depreciation, either the resulting overall depreciation of the dollar will be too small, or currency appreciation will fall heavily on economies where a further large appreciation will not be warranted by their economic circumstances. Currency manipulation by China (and some others in Asia) thus can make it all the more difficult to achieve the needed global rebalancing of payments positions. No exchange rate system will operate effectively if surplus countries take measures to prevent or to tightly limit real exchange rate appreciation.

Given its obligation to exercise firm surveillance over the exchange rate policies of member countries, one might have expected that the IMF would be constantly on the lookout for abuses and active in seeking remedial actions. Not so. During the past 25 years, there have been only two cases (Sweden in 1982 and the Republic of Korea in 1987) in which the IMF was willing to send a special consultation mission to investigate an exchange rate problem.[10] In the case of China, the IMF has stated that it favours increased flexibility, but has not defined by how much or when the RMB would need to change to meet the standard of increased flexibility. The IMF's Managing Director, Rodrigo de Rato, has also stated that he sees no proof that China has engaged in currency manipulation. No wonder that Timothy Adams (2005), the US Under-Secretary of the Treasury for Monetary Affairs, has recently charged the IMF with being "asleep at the wheel" on its most fundamental responsibility of exchange rate surveillance—a concern also shared here.[11]

The greater the perception that international rules of the game are not being enforced, the greater the likelihood that currency issues will be handled bilaterally, with less attention paid to the proper fundamentals. In this connection, there are currently a set of bills before the US Congress (for example, Schumer-Graham bill) that seek to impose a surcharge on China's exports to the United States if (bilateral) negotiations fail to bring a timely end to the large undervaluation of the RMB.

To sum up, the weight of emerging economies in the global economy is increasing. How emerging economies manage their exchange rates will matter not only to them, but also increasingly to the rest of the world. In the next 10 years, international norms and guidelines for exchange rate policy will be no less necessary than those for trade policy. If those currency guidelines are neither interpreted sensibly nor enforced vigorously, there will be increased conflict and a heightened risk of protectionist responses. To avoid that unhappy outcome, the IMF should give substance to its mandate to exercise firm surveillance over countries' exchange rate policies. More specifically, the IMF should: begin issuing its own semi-annual report on exchange rate policies (where, among other things, cases of potential currency manipulation would be identified); make more frequent use of special consultations (whenever either IMF staff or another member country has raised a serious concern about potential currency manipulation); and review its existing guidelines for surveillance over exchange rates to see whether they warrant any modification.[12]

Currency mismatches

A currency mismatch here means a situation where the currency composition of assets and liabilities differs, so that an economy's (or sector's) net worth or its net income becomes sensitive to changes in the exchange rate. For example, suppose that the liabilities of the corporate sector in county x were primarily denominated in US dollars while its assets were mainly denominated in local currency. A large depreciation of the currency of country x relative to the dollar could render that sector insolvent.

Why worry about currency mismatches in emerging economies? There are three reasons.

First, there is strong empirical evidence that currency mismatches increase not only the probability of getting into a financial crisis but also the cost of getting out of one. All the prominent, emerging market financial crises of the past decade (Mexico in 1994–95, Asia in 1997–98, the Russian Federation in 1998, Turkey in 2000–02, Argentina in 2001–02 and Brazil in 1998–2002) have been marked by large currency mismatches. Currency mismatch variables have proved to be one of the better-performing leading indicators of currency and banking crises in emerging economies, and output contractions in the 1990s have been deeper in emerging economies with large currency mismatches and large exchange rate depreciations.

Second, sizable currency mismatches undermine the effectiveness of monetary policy during a crisis. Sizable currency mismatches make it harder to reduce interest rates after a deflationary shock, because the authorities worry that an interest rate decline could set off a sharp fall in the currency, which in turn could initiate a wave of bankruptcies. In contrast, when currency mismatches are small, interest rate cuts can stimulate the economy.

Third, currency mismatches can severely constrain the operation of floating exchange rates in emerging economies. When currency mismatches are large, the authorities are apt to engage in heavy intervention in exchange markets and in management of interest rates to keep the exchange rate from depreciating sharply. But such a "fear of floating" sacrifices the benefits of monetary policy independence and of better cushioning against external shocks.

Currency mismatches in emerging economies are not inevitable. The good news is that aggregate currency mismatch has declined substantially in most emerging economies since 1997–98, particularly in Asia.[13] The bad news is that in some larger emerging economies in Latin America and in Eastern Europe mismatch has worsened over the past six or seven years, and the improvement that has occurred elsewhere could prove transient if the right policies are not followed.

But what are the right policies for controlling currency mismatch in emerging economies? Goldstein and Turner (2004) offer the following answers:

- Those emerging economies that are substantially involved with international capital markets should opt for a currency regime of managed floating. The de facto movement of the nominal exchange rate will produce an awareness of currency risk, as well as an incentive to keep currency mismatches under control. A monetary policy framework of inflation targeting should be employed to provide a good nominal anchor against inflation. Good inflation performance is crucial for developing a healthy local currency–denominated domestic bond market.
- Banks in emerging economies should apply tighter credit limits on foreign currency–denominated loans to customers that do not generate enough foreign currency revenues. Banking supervisors should strengthen regulations and capital requirements on banks' net open positions in foreign exchange.
- To help harness the forces of market discipline, the IMF should regularly publish data on currency mismatches at the economywide and sector levels and should comment on those mismatches regarded as excessive. The IMF should also make reduction of currency mismatches a condition for IMF loans in cases where the actual or prospective mismatch is deemed to be too large.
- Emerging economies that have a high share of public debt denominated in, or indexed to, foreign currency should adopt a medium-run objective of reducing that share; for countries with a poor track record on inflation, inflation-indexed bonds can serve as a useful transition device to fixed-rate, domestic currency–denominated debt. Higher priority in emerging economies should be accorded to enlarging domestic bond markets, to encouraging the use of hedging instruments and to reducing barriers to the entry of foreign-owned banks.

To sum up, it is difficult to find a factor in emerging economy financial crises of the past decade that has been more prevalent and more destructive than currency mismatches. While a good start has been made, much remains to be done to implement an effective strategy for controlling currency mismatches. The sooner such a program is carried through, the better.

Debt sustainability

The last decade has witnessed not just a host of currency and banking crises but a spate of debt crises as well: recall Argentina, Ecuador, Pakistan, the Russian Federation, Ukraine and Uruguay—to say nothing of the close calls in Brazil and Turkey.

Anyone who thinks that severe debt problems in emerging economies are now a thing of the past should read the September 2003 and September 2005 issues of the IMF's *World Economic Outlook*, which ask whether public debt in emerging economies is too high. They answer that question with an emphatic "yes."

According to the IMF's (2003a) analysis, the average ratio of public debt to gross domestic product (GDP) had grown by the end of 2002 to 68% in emerging economies, reversing the progress made in reducing that ratio during the first half of the 1990s and bringing the emerging economy average to a level higher than that in industrial countries.

Equally if not more troubling, the IMF documented that over half of public debt defaults occurred at public debt ratios below 60%, that the typical emerging economy had (in 2002) a public-debt ratio about two-and-a-half times as high as its track record on fiscal policy suggested was prudent and that emerging economy governments usually failed to take corrective fiscal policy actions when the public debt ratio climbed above 50%.

To be sure, those averages concealed considerable cross-country variation. For example, because of relatively high growth rates, high trade openness and a relatively low share of foreign currency–denominated debt, Asian emerging economies overborrowed less than their counterparts in Latin America, the Middle East and Africa. Still, the fiscal costs of bank restructuring had pushed up considerably public debt ratios in Asia since the mid-1990s, and the region's relatively high ratio of public debt to government revenues provided little ground for complacency.

More recently, the IMF (2005) revisited the emerging-market debt situation and found encouraging progress. Specifically, the average public debt ratio (relative to GDP) had fallen by 8 percentage points between end-2002 and (projected) end-2005, bringing to about 60%. The improvement was most pronounced in Latin America, followed by the Middle East and Africa and Asia. In contrast, average public debt ratios increased slightly in the emerging economies of central and eastern Europe. Notably, the structure of public debt also improved, with the average share of foreign currency–denominated debt in the total having fallen by roughly 5 percentage points over the past three years.

The IMF (2005) cautioned that the recent (2002–05) decline in public debt ratios occurred during an unusually favourable set of economic circumstances for emerging economies—including real exchange rate appreciation for their currencies, historically high growth rates of real GDP, buoyant commodity prices and an increase in financial market risk appetite.[14] It also concluded that an average public debt ratio of 60% of GDP was still too high, and that debt-related vulnerabilities should be reduced further.

In a similar vein, Goldstein (2003) argues that we have in the past been too optimistic about the prudent level of public (and external) debt in emerging economies. We have not paid enough attention to the foreign exchange constraint facing governments; to contingent liabilities that start out in the private sector but don't stay there; to spillovers among currency, banking and debt problems; to the high volatility in many emerging economies; and to the too-frequent resort to exchange rate–linked domestic debt.

A crucial question is, what can be done to reduce vulnerability to debt crises?

At the individual country level, much can be done to broaden tax bases, to shoot for fiscal surpluses during cyclical upswings, to limit the generosity of official safety nets directed towards banks and other financial institutions and to reduce, over time, the now excessive dependence on foreign currency–denominated and linked debt. (The IMF also supports these actions.) For its part, the IMF should be much tougher than in the past in making debt sustainability a key condition for IMF lending. In June 2002 the Fund began implementing a common framework for more rigorous assessments of public and external debt sustainability. This is a step forward—even if the first review of this framework by IMF staff (IMF 2003b) found that baseline projections for debt had an overly optimistic bias and that the sustainability analysis had not yet become a major part of either the staff's analysis or of the discussions between the staff and country authorities. The way ahead should be to continue to work towards making the Fund's debt sustainability analysis as competent and objective as possible, to insist that publication of this debt sustainability analysis be mandatory and to require stringent approval and accountability requirements for exceeding normal access limits on IMF loans.

To provide greater cushioning for emerging economies' ability to pay, the official sector ought to be encouraging both the private financial sector and emerging market borrowers to experiment with the use of GDP-indexed bonds. This is a more realistic and more straightforward option than creating, say, new emerging-market currency indexes.

And in cases where debt restructuring is the only realistic way out of an unsustainable debt situation, continued and yet wider use of collective action clauses will be helpful in making restructuring more orderly and timely.

Notes

1. Goldstein (2005d) provides a fuller treatment of the issues surrounding reform of the international financial architecture.
2. According to the IMF's *International Financial Statistics* (October 2005), the economies of emerging Asia held 43% of global non-gold international reserves, as of June 2005.
3. The "wrong" exchange rate means a real exchange rate that differs from the equilibrium rate implied by economic fundamentals.
4. Goldstein (2005b) also dismisses several other denials of, or rationalizations for, currency manipulation, including: the argument that a country that maintains a fixed exchange rate cannot be guilty of manipulation, the argument that increases in inflation rates in countries with undervalued exchange rates will soon undo efforts to manipulate the currency and the argument that manipulation aimed at currency undervaluation should be tolerated in cases where rapid growth of exports is (allegedly) necessary to maintain employment growth and social stability.
5. Between February 2002 (when the US dollar hit its peak) and December 2004, the real trade-weighted value of the RMB fell by 10% according to JP Morgan's index and by 12% according to Citigroup's index. China ran global current account surpluses (expressed as a share of China's GDP) of 3.3% in 2003 and 4.2% in 2004; its surpluses on capital account were even larger in those two years—in the vicinity of 7%–8% of GDP. As a result, China's international reserves increased by roughly 12% of GDP in both 2003 and 2004. In the meantime, China's economy was growing by over 9% a year in 2003–04, while price pressures and growth rates of bank credit and the monetary aggregates were accelerating. In the end, it took strong

administrative controls on bank lending, on investment project approvals and on land use to rein in these domestic imbalances. But these measures carry their own costs. See Goldstein (2004, 2005a) for a discussion of these issues.

6. For the first three quarters of 2005, China's real GDP growth again exceeded 9%, but there are some tentative signs of a slowing in the growth of real final domestic demand. This latter development is not a good reason to forgo a sizeable RMB revaluation; see Goldstein (2005a).

7. From end-December 2004 through October 2005, the real trade-weighted exchange rate of the RMB appreciated by 10% according to the JP Morgan index and by 3% according to Citigroup's index.

8. The real depreciation of the RMB was 1% on the JP Morgan index and over 9% on the Citigroup index.

9. See Mussa (2005).

10. See Goldstein (2005b).

11. See Goldstein and Mussa (2005).

12. See Goldstein (2005b) for a further elaboration of these proposals.

13. See Goldstein (2005c).

14. Goldstein (2005c) spells out in some detail the nature of the favourable global operating environment facing emerging economies over the past several years, along with the type of risks that could bring those favourable external conditions to an end.

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Financial Stability: A Global Public Good

3 Chapter

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This study discusses the global public good of financial stability through collective actions to monitor, report and control currency mismatches. Addressing the issue of emerging market currency mismatches is likely to yield the greatest near-term benefits compared with other policy interventions to ensure financial stability. Many negative elements of currency mismatches arise from excessive use of foreign currency debt contracts and can be addressed by developing local currency bond markets as alternative financing. But caution is warranted where local currency bond markets are used principally to address excess liquidity—due to sterilization of foreign exchange markets trading fixed and undervalued currencies.

The current practice of generic bond issuance by international financial institutions is too limited to stimulate local currency debt markets. Rather, an expanded commitment by these institutions to local currency debt products would work better—including active trading of currencies, swaps, futures and derivatives.

On currency mismatches, establishing an independent Financial Stability Agency—to centralize monitoring and reporting financial vulnerability—might address policy inflexibility. Early detection of vulnerability leads to earlier intervention, and thus crisis prevention.

Financial stability is a global public good because of the tendency for financial turbulence to spill across borders—the "contagion" effect (Eichengreen 2006; World Bank 2005). While normal financial volatility is priced through higher risk premiums and requires little intervention, turbulence leads to excess volatility, which has a strong negative link to growth. Volatility and instability can lead to financial crisis and significant losses in output as vulnerable countries suffer high economic costs in restructuring. And instability craves company—it cannot be stopped at the border. As it spreads rapidly across a region, as with the 1997 Asian financial crisis, it can be devastating to the poor, who in effect become collateral damage in a crisis (Cornia 2001).[1] With all this at stake, governments and multilateral organizations need to devote much time and effort defining and implementing measures to prevent, contain and resolve financial crises.

Any discussion of financial stability invariably centres on emerging market economies.[2] A crisis is usually assumed to occur because of untenable debt burdens and ensuing market speculation. However, many influences are at work. Too often reforms in emerging market economies focus on reducing debt rather than systemically restructuring the composition of debt.

One of the causes of emerging market crises was effectively poor balance sheet management. A "double mismatch" occurred because liabilities were not matched with liabilities in either tenor or currency. Debt maturities tended to be too short, leaving borrowers subject to interest rate risks. And the now largely discontinued practice of issuing emerging market debt to match the maturity that suited the market rather than the sovereign issuer was common. Issuers and underwriters attached greater importance to the issuer's credit spread remaining unaffected than to the financing needs of the economy—the net result being maturity bunching.

The most significant blunder, however, was the failure of many countries to come to terms with the currency mismatch problem caused by over-reliance on foreign currency debt contracts. A key element of currency mismatch management in the 1990s was the belief that the denomination of debt contracts was largely irrelevant when exchange rates are fixed and accompanied by an assumed sufficient, protective level of reserves. The Asian financial crisis ended this thinking.

The scale of a currency mismatch cannot be foreseen, and its "knock-on" effects are extremely significant, particularly where the bulk of a country's debt contracts are in foreign currency. If a currency halves in value while debt denominated in foreign currency remains static, the debt service burden in local currency terms doubles. Mismatches also lead to further currency vulnerability, with the vicious cycle of devaluation leading to major debt restructuring requirements, precisely when a country's negotiating power is weakest.

Currency effects can dwarf actual changes in net cross-border debt flows. In 2002 unfavourable exchange rate movements neutralized debt reduction in Indonesia and many other emerging market economies.

They materially affect the debt restructuring process. In 2002, Argentina repaid and restructured its outstanding debt by $5.4 billion, only to see the price of that debt rise by $7 billion because of adverse currency revaluations (World Bank 2005).

Currency mismatches have been a remarkable leading indicator of financial crises in emerging markets. Output contractions have been deeper in countries with large currency mismatches and devaluations (Goldstein 2006). Because mismatches are present in most financial crises, it follows that policies to reduce them should increase financial stability and thus limit the risk of financial contagion across a region (or subregion). A negative or deteriorating currency mismatch identifies an economy that may be vulnerable to large-scale short-term capital outflows or external shocks. Speculative traders in financial markets build positions based on an economy's perceived vulnerabilities, so it is critical for policy-makers to acknowledge the market's view of a currency's susceptibility to weakness.

There are many policy initiatives that multilateral development agencies can take to build financial stability and contain financial crises (see table 3.1). Given how markets interconnect, these measures will frequently overlap. For example, an effective way to reduce a currency mismatch in emerging markets is to foster the development of local currency debt markets that boost investment opportunities by offering diverse products in an active trading environment. Active debt markets expand local currency financing options to a broad range of issuers, thus reducing reliance on foreign currency–denominated debt. Wider investment choice in domestic markets also encourages local investors to stay at home.[3]

The role played by international financial institutions as issuers in domestic bond markets deserves some examination as several of the supposed benefits of this kind of intervention as a global public good may have been overstated. One-off issuance using traditional distribution channels seems to do little to enhance liquidity or encourage a broader investment base (EIB 1999). Bonds issued by international financial institutions tend to be purchased by buy-to-hold investors and do not circulate regularly, negating the argument that they can raise liquidity and are instrumental in creating a credit curve for high-quality issuance.[4] However regular issuance that uses varying and non-traditional distribution channels (such as promoting retail interest) or extends maturities available for investment may be of some benefit. The tenets of issuance need to be more rigorously examined, and the nature of the strategy behind intervention in domestic markets needs to be more clearly defined before we can declare it a global public good.[5]

Table 3.1 Some multilateral efforts to prevent and contain financial crises

Action	Global public good	External benefit
Monitoring and reporting currency vulnerabilities	Yes, if impartial, timely and not contingent on government approval	Provides early warning of regional financial susceptibility, leading to crisis prevention or containment
Participation of international financial institutions[a] as issuers in local currency debt markets	Partly	Encourages greater investor choice in tenor or credit quality Encourages a more diverse investor base
Promoting financial price efficiency	Yes	Lowers transaction and intermediation costs Leads to efficient use of capital
Developing local currency debt markets	Yes	Reduces risk for borrowers as exchange rate risk is assumed by the lender Reduces investment capital leakages from emerging markets into international debt markets
Controlling currency mismatches or manipulations	Yes, if timely	Reduces the risk of bilateral action that may be politically as well as financially motivated
Disseminating information	Yes, if coordinated	Strengthens financial links Provides development road maps or best practices to minimize financial sector vulnerabilities
Encouraging cross-border investment	Yes	Creates links to strengthen emerging market financial systems Broadens investor base
Enacting collective action clauses	Yes	Shortens restructuring time, possibly reducing the risk of financial contagion

a. "International financial institutions" usually refers to the International Monetary Fund and World Bank, but can extend to any regional development agency. It is often used interchangeably with "multilateral development bank" or "multilateral development agency".

Promoting financial price efficiency is a global public good because it lowers transaction and intermediation costs. In international debt markets low transaction costs enhance efficient price intermediation across financial products. By reducing price anomalies between products, a market moves towards an efficient allocation of scarce capital. The transference of pricing instruments that promote efficiency in emerging markets becomes part of this public good when we consider that many investors use poor transaction capability as one of the major reasons for moving investments away from domestic markets.

Information dissemination is clearly a global public good. Opaque financial systems discourage investment, particularly from external sources. Potential investors in new emerging markets find themselves mining multiple information sources—many out of date—to arrive at some overview of the domestic financial system. This slows the investment approval process in organizations. Initiatives assisted by multilateral institutions include the Asian Development Bank's AsianBondsOnline information portal,[6] which aggregates available information on East Asian domestic markets as part of the Asian Bond Markets Initiative. This web site also provides a process-driven overview of how to physically transact in these markets. Access to this type of information encourages wider investor participation, both domestically and internationally. In order to further transparency, multilateral agencies in other regions are looking into creating information portals similar to AsianBondsOnline.

Collective action clauses (CACs)[7] are a global public good because they discourage the small investor or lender from disrupting the debt restructuring process—at least in theory. Bonds with CACs usually attract an extra spread premium, which tends to depend on overall market conditions, but is ultimately borne by the issuer (Eichengreen, Kletzer and Mody 2004). Also, collective action clauses may not be in place for all debt securities of an issuer. There is evidence to suggest that sovereign bonds—some with collective action clauses and some without—actually complicate the debt restructuring process.

Cross-border investment also promotes financial stability if it augments, not replaces, the existing investment base. High investor concentration grants disproportionate power to the bondholder. By widening the investor base to include different classes of investors, with different investment parameters, emerging market economies can protect themselves from the threat of one-way portfolio flows. Many emerging market economies, particularly in Asia, have created incentives for offshore investors to enter markets and thus build this type of protection.

However it is in recognizing and identifying currency vulnerabilities in emerging markets—and taking steps to reduce their potential negative impact—that the international community will derive the greatest benefit in terms of financial stability.

Currency mismatches—fuel for a crisis

A currency mismatch occurs when the assets and liabilities of an organization, economy or sector are not denominated in the same currency, causing increased sensitivity to changes in exchange rates. If liabilities are primarily denominated in foreign currency with assets in local currency, then depreciation in the local currency could render the country or sector insolvent. This can be exacerbated further if revenue or income in foreign currency cannot adequately cover debt service charges.

As corporations globalize, currency mismatches have become well recognized. Remedial actions, such as matching funding of currency liabilities to productive income, have long been a part of many corporations' financial structuring.

The situation differs somewhat in emerging market economies. According to the doctrine of "original sin" in emerging bond markets,[8] the inability of emerging market economies to borrow in their home currency on international markets limits local currency finance to domestic sources. Thus they must assume foreign currency exposure, primarily to the US dollar. But this argument ignores using local currency bond markets as an alternative financing option for both public and private sectors. The de facto acceptance that there was no viable outside source for local funding—implicit in the "original sin" hypothesis—led some emerging market economies to an over-reliance on international capital markets, at the expense of setting clear policies to develop local currency bond markets. Due to this lack of productive local fixed-income investment opportunities,[9] the dependency on one financing pool[10] likely drove potentially available domestic investment capital out of the economy.

There is evidence that currency mismatches not only increase the probability of financial crisis, but also raise the cost and increase the difficulty of getting out of one (Goldstein and Turner 2004). Sizeable mismatches make it harder to ease interest rates after a deflationary shock because they risk causing a further decline in the exchange rate. This creates the potential for a vicious cycle of currency declines accompanied by bankruptcy and contracted economic activity, all leading to the perception that there are no policy options left. This in turn feeds into a lack of confidence in the financial system, causing further currency depreciation.

Heavy reliance on intervention in currency and interest rate markets—at the expense of monetary policy independence—multiplies the challenges policy-makers face in adopting measures to cushion the economy. The longer it takes to resolve a crisis, the greater the risk of financial contagion, that is, a crisis spreading across the region.

Measuring mismatches

No single measure completely captures a currency mismatch or its effect on financial stability. Any sincere effort must focus on how a change in the exchange rate will affect the present discounted value of future income and expenditure. Key determinants will include the currency denomination of financial assets and liabilities and future income and expenditure flows, in addition to returns on capital assets.

Many indicators use levels of public sector debt as the cornerstone of any discussion of an economy's vulnerability to a currency mismatch. These measures may not be broad enough to capture an economy's vulnerability to a currency mismatch. A consequence of financial contagion is that governments frequently assume private sector assets, which occurred with banking assets in Asia during the 1997 crisis. Another factor that requires that corporate foreign currency debt exposure is added to sovereign ratios is the tendency for governments to guarantee debts of significant quasi-corporate organizations in such key industries as refining and power.

Several useful measures of an economy's vulnerability to external shocks might include ratios of the total short-term foreign debt to foreign exchange reserves and total external debt to gross national product. Ratios of reserves to imports and total debt service to exports are two others. However these indicators only address the short-term vulnerabilities that exist because of debt burden; through debt-servicing charges or short-term repayment pressure. They do not present an easy-to-read debt picture of the economy as a whole.

Because of its simplicity and effectiveness, a useful indicator is the aggregate effective currency mismatch (AECM) index, developed by Goldstein and Turner (2004). The index measures a country's financial vulnerability to currency mismatches in terms of income and expenditure flows and has proved reliable when back-tested against crisis-affected countries.[11]

A simple exposition of the mismatch concept is a two-step process. The initial mismatch variable is defined as

$$MISM = \frac{FC\%TD}{X/Y}$$

where *MISM* is mismatch, *FC%TD* is foreign currency share of total debt and *X/Y* is exports to GDP ratio (as a proxy for the share of tradable goods in total output).

MISM equals 1 if *FC%TD* equals *X/Y*. As *MISM* increases above 1, the degree of mismatch increases. What distinguishes this definition from others is that it takes into account all assets and liabilities—not just cross-border assets and liabilities. The denomination of foreign currency contracts between residents matters because a sharp change in the exchange rate can disrupt these contracts, with real economic effects. Government debt and deficits might explode or companies and banks fail if the exchange rate shock is great enough. Foreign currency debts between residents can "cancel out" in normal times, but might not in a crisis. Indeed, it is the disruption of foreign currency local contracts that aggravate many emerging market crises.

How much exchange rate depreciation affects a country's balance sheet—that is, on its position vis-à-vis non-residents—depends on the country's net liability position in foreign exchange (that is, net foreign currency assets, or *NFCA*). The index of "effective" currency mismatch, *AECM,* is simply given by the product of these two variables.

$$AECM = \frac{NFCA}{Y} * MISM$$

If foreign currency assets equal foreign currency liabilities, then *AECM* is zero—that is, there is no "effective" mismatch. If a country has a net liability position in foreign exchange (that is, *NFCA* is negative), *AECM* will also be negative. The index is meant to show the level of disruption of any large and sudden currency depreciation. A positive *AECM* indicates less vulnerability, while a negative score indicates some vulnerability.

Table 3.2 shows the AECM for the five economies most affected by the 1997 Asian financial crisis—Indonesia, the Republic of Korea, Malaysia, the Philippines and Thailand—plus China and Viet Nam. It offers a useful comparison for the value of the AECM on both sides of the crisis. China and Viet Nam had positive ratios throughout, reflecting a low reliance on foreign debt financing and therefore less vulnerability to currency depreciation.[12] Indonesia, the Republic of Korea, the Philippines and Thailand showed negative AECMs between 1996 and 1998, while Malaysia had a mildly negative AECM in December 1997. Each of these markets had currency realignments during the crisis. By the end of 2003 all market ratios of the five countries, except the Philippines, showed positive AECMs. This reflects significantly less vulnerability to currency mismatches throughout the region.

Table 3.2 Year-end aggregate effective currency mismatch index and the 1997 Asian financial crisis (%)

Year	China	Indonesia	Korea, Rep. of	Malaysia	Philippines	Thailand	Viet Nam
1995	3.7	–8.8	–1.3	2.3	0.8	–7.1	
1996	5.1	–8.2	–5.3	1.3	–2.0	–11.0	3.3
1997	7.3	–20.8	–11.1	–0.9	–8.0	–16.7	3.6
1998	6.4	–18.5	–2.9	2.0	–7.1	–6.5	4.8
1999	4.9	–6.9	1.7	3.1	–7.9	–0.3	4.1
2000	3.7	–2.2	3.2	1.9	–10.0	2.1	4.3
2001	3.7	0.6	3.9	2.1	–13.4	4.1	4.4
2002	2.5	2.5	2.9	1.3	–14.2	4.8	3.6
2003	2.4	2.9	3.9	2.7	–18.7	5.0	3.0
2004	3.2	2.0	4.3	4.3	–17.8	4.1	2.2

Source: Updated data from the Bank for International Settlements (June 2005) except for Viet Nam (AsianBondsOnline calculations).

Controlling and reducing currency mismatches and exchange rate manipulation

While useful as a starting point, currency mismatch indicators have some fairly serious limitations in assessing some facets of emerging market debt vulnerability. The AECM is an aggregate measure, so it does not capture the extent to which long-term debt contract coupons are linked to movements in short-term interest rates.[13] This subjects the economy to an added interest rate risk not reflected in the term structure of outstanding debt, and has large-scale implications for financial security. Financial crises are normally accompanied by major spikes in short term interest rates. During a crisis, a country's overexposure to debt linked to short term interest rates can result in a substantial and unforeseen increase in financing costs. Additional indicators that examine the composition of debt contracts are needed to monitor this risk.

By developing local currency debt markets, adding to foreign reserves and reducing reliance on foreign currency–denominated debt instruments, emerging market economies can reduce their aggregate currency mismatches. Emerging market economies create much more resilient "balance sheets" that can help them weather market shocks. However, some of these "remedies" also carry associated risks to financial stability. Where domestic bond markets develop rapidly in terms of size, improvements to transaction efficiency frequently lag behind. The limited ability of institutional investors, for example, to transact holdings can compromise the stability of the financial sector. In general, improvements to transaction liquidity have not kept pace with domestic bond market asset growth in many emerging markets. Despite a 20% annual

Table 3.3 Selected Turnover Ratios in Asian Domestic Bond Markets

Market	1999[a]	2001	2005[b]
China	2.48	1.68	2.24
Hong Kong, China	40.77	48.07	53.35
Indonesia		0.69	0.65
Japan	5.6	4.51	4.66
Korea, Rep. of	2.65	5.87	3.34
Malaysia		2.48	1.85
Singapore	2.03	5	2.8
Thailand	0.64	1.65	1.89

a. Blank means data not available. **b.** 2005 data for PRC and Indonesia are 2004 turnover ratios.
Source: AsianBondsOnline

growth in the size of outstanding government bonds, several East Asian bond market turnover ratios have dropped (see table 3.3).[14] This occurred in an environment where emerging market investment is booming, suggesting that the ability of bondholders to clear positions might be severely compromised in times of stress. The mutual fund crisis in Indonesia in 2005 indicates that this scenario is not far fetched.[15]

Reserve accumulation is also regarded as a prudent financial stability tool in emerging markets, as it creates a buffer against financial shocks from exchange rate speculation and one-way portfolio flows. But the highly successful accumulation of foreign reserves within Asia since the 1997 financial crisis could conceivably create risks to both domestic and global financial systems. Emerging market economies need to adjust to their new importance in addressing financial market and global payments imbalances. Reserve management has major ramifications beyond national boundaries, particularly when foreign reserves are reallocated across currencies. But a reserve accumulation that dwarfs the size of the domestic financial system also complicates the sterilization process. In the event of prolonged policies that restrict local currency appreciation, governments need to issue domestic securities to drain excess liquidity. Without this escape valve, domestic lenders could easily be encouraged to lend into more speculative assets classes—such as real estate or consumer credit—potentially causing troublesome asset bubbles.[16] Similarly, countries with currencies perceived artificially undervalued encourage inflows from investors into debt and equity markets, potentially encouraging overinvestment and increasing vulnerabilities.

Aside from creating a high level of reserves, fixed exchange rates have short- and long-term implications on a currency mismatch. Fixed exchange rates can also lead to a cavalier approach to managing currency mismatches by both the public and private sectors. A fixed exchange rate can lead to above-optimum accumulation of foreign currency–denominated debt, particularly if considered an immutable part of government policy. Both private and public sector borrowers may access international pools of capital without properly hedging their currency risks. Over-concentration of foreign borrowings could discourage authorities from shifting to a floating rate regime for fear of igniting a currency crisis.

Emerging economies currently punch above their weight in the global economy. Growth in cross-border emerging market investment means that any crisis can no longer be contained—even within a region.[17] Exchange rate management increasingly matters to the rest of the world, and the globalization of financial assets means that exchange rate policies will inevitably attract the same scrutiny as trade regimes. There will likely be more pressure for policies to show greater cohesion. Previously, international financial institutions preferred to treat exchange rate manipulation and currency mismatches as sovereign issues, resulting in some very interesting outcomes.[18] It is likely that inappropriate exchange rate behaviour may soon attract the same types of penalties as trade sanctions. This applies equally to an increasing currency mismatch as it does to exchange rate manipulation.

International financial institutions need to take a stronger stance on currency levels, given that currency manipulation might eventually risk bilateral action motivated not by sound economics, but by politics in the aggrieved country. This has arguably already occurred in the imposition of trade tariffs, and it could eventually carry over to a currency response. In the past, coordinated financial action—such as the 1985 Plaza Accord to reduce the strength of the US dollar—has not been frequent. With the growing importance of emerging markets, there may be a case for more regular and definitive responses to ensure financial stability.

The current situation

In the early 1990s, the common theme was that local currency bond market development was a waste of time, as little or no savings pools could be mobilized (such as in Latin America or in Central Europe), or that the local investor psyche was not attuned to fixed income allocation (as in arguments against emerging Asian domestic bond markets). The Asian financial crisis convinced governments that the creation of local currency bond markets was essential to reduce the impact of currency

Table 3.4 **Domestic debt securities outstanding (US$ billions)**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005[a]
Latin America[b]	274	317	395	468	518	445	488	537	421	533	648	842
Argentina	30	26	29	34	40	43	47	37	18	20	22	23
Brazil	173	231	297	345	391	294	298	312	212	300	372	520
Mexico	41	24	27	41	40	59	87	130	133	145	174	210
China	46	67	87	116	167	215	266	316	377	440	528	633
India	64	71	81	75	86	102	114	130	156	203	250	283
Korea, Rep. of	185	227	239	130	240	266	269	293	381	446	569	638
Other Asia[c]	199	229	288	259	317	390	408	434	488	554	620	647
Central Europe[d]	39	47	52	50	65	68	71	90	130	164	215	205
Russian Fed.	3	17	43	65	8	9	8	5	8	12	21	24
Turkey	16	21	27	30	38	43	55	85	92	140	170	184
South Africa	97	98	79	80	69	69	58	39	54	79	105	96
Total[e]	923	1,093	1,286	1,268	1,496	1,591	1,715	1,903	2,075	2,535	3,078	3,426

a. The 2005 data for China, Korea and Other Asia are estimates by AsianBondsOnline; data for other markets refer to end-September 2005. **b.** Latin America includes Argentina, Brazil, Chile, Colombia, Mexico and Peru. **c.** Other Asia includes Malaysia, Taiwan, Hong Kong, Singapore, the Philippines, Thailand and Indonesia. **d.** Central Europe is the total of the Czech Republic, Hungary and Poland. **e.** The total is the sum of the countries and areas shown.

Source: Bank for International Settlements and AsianBondsOnline estimates.

mismatches. The size of local currency emerging markets now exceeds $3 trillion, a threefold increase from 1994 (see table 3.4). Local investors fuelled much of this growth, in part due to definitive government policies on pension fund reform. While Asia was responsible for much of the increase in size—accounting for 62% of the total market—most regions have advanced. With Turkey's domestic bond market tripling in size, its AECM moved from –24.6 in 2000 to –11.4 in 2004.[19]

It is tempting to be self-congratulatory about the changes in emerging markets, particularly as the emergence of local currency debt markets has led to general reductions in currency vulnerability. But growth in domestic bond market size alone is not a panacea for eliminating financial vulnerability, if it accompanies increases in all forms of debt, resulting in little or no change in debt composition or the quality of that debt. In this instance, there is reason to be concerned that credit expansion could lead to asset bubbles.

Developing domestic markets that are viable under all conditions and available to all types of issuers and investors is imperative. Emerging bond markets remain dominated by government issuance, while poor transaction liquidity poses risks. An improved environment for issuers will reduce the potential for currency mismatches as corporations come to regard local currency markets as a suitable alternative funding source. This will not happen until increased market liquidity creates efficient markets.

To do this, the role of international financial institutions needs to move forward. Thus far international financial institutions have entered domestic bond markets simply to increase the supply of highly rated corporate paper. However, one-off issuance seems to achieve relatively little, as it does not significantly add liquidity, nor does it seem to help develop a credit curve.[20] While governments and international financial institutions can drive bond markets forward by the judicious use of policies and financial clout, actions need to be based more on facilitation, not just determination. Given this, international financial institutions should be more aggressive as they delve into local currency debt markets, as many of the following recommendations emphasize.

International financial institutions also need to expand monitoring and reporting of financial imbalances. To be effective, this needs to be largely free of government interference. A currency mismatch is essentially a leading indicator—part of an early warning system—of financial vulnerability for a country or region. To be considered an effective global public good; reporting must be both impartial and timely. One criticism of government-sponsored early warning systems is that political sensitivities can compromise model results, as thresholds for warning signals can be manipulated at the country level, reducing objectivity. Governments obviously want as few signals of financial market vulnerability as possible, particularly if results are available in the public domain. A truly effective model should flag a variety of risks well before vulnerability turns into contagion.

Thus international financial institutions should be allowed the role as uncompromising reporters of mismatches for the public good. The key is the strict adherence to impartiality. In some cases, this might require a rethink of the whole process of intraregional and global reporting. Some institutions tend to clear potentially controversial statements with relevant governments, which weakens the entire monitoring process. Agreeing on measurement standards first and limiting government interference in report output might better serve the process.

In April 2006 members of the International Monetary Fund (IMF) began to address this need for change by endorsing a new framework aimed at monitoring economic policies that cause global imbalances.[21] It emphasizes the need to be more systematic and pragmatic in how it gives policy advice to members. The Fund stressed the need to

- Focus and publicise advice to individual countries where vulnerabilities may have significant impact, with particular emphasis on financial markets.
- Involve regional multilateral agencies in individual consultation.

- Place greater emphasis on exchange rate policies and their effect on financial stability.
- Ensure that IMF action is timely, with financing methods more appropriate to the needs of member countries with vulnerable financial systems.
- Give emerging market economies a stronger and more proportional voice in running the IMF.

These goals begin to address criticisms of the IMF that recent interventions[22] have been both too late and too inflexible, and that loan conditionality favoured the interests of the G-7[23] at the expense of emerging markets. Key to the success of the proposal is the "buy-in" of many emerging market economies that have been previously critical of IMF interventions.[24]

One major unresolved issue is which monitoring process will be adopted and who will be responsible for data calculation and monitoring. At present most multilateral agencies prepare statistics on financial vulnerability based on country coverage. Markets are drowning in data, but there has not been sufficient distillation from a practical viewpoint. There is much duplication of effort and no universal agreement as to what constitutes an acceptable indicator.

The earlier discussion of the AECM provides some guidance as to what could constitute a reliable indicator of financial stability—one that is comparable, capable of easy and transparent calculation across a wide range of economies, reliable when back-tested for crisis-affected countries and unambiguous.[25] Crucially, major indicators, such as the AECM, should be able to be dissected so component risks can be analysed.

Summary

General, but not uniform, reductions in emerging market currency mismatches go a long way towards reducing the risk of contagion. Recent improvements in emerging market currency mismatches during 1995–2004 should not be used as a rationale for not further improving monitoring and reporting currency vulnerabilities. As emerging market influence on the global economy continues to grow, so does its influence on the international financing system. This has increased the importance of monitoring and reporting, as well as the involvement of international agencies in ensuring stronger, more liquid financial systems in these markets.

Recommendations

Proscribed prudential conduct by international financial institutions over a country's financial affairs often hurt those who should be helped the most. Post-crisis "remedies" are often punitive penalties, open to accusations of being both inappropriate and small-minded. Therefore approaches are favoured that reward economically responsible behaviour and ensure that interventions occur earlier in the cycle of worsening economic fundamentals. Some recommendations could be problematic, so should be used selectively.[26] It is important to build a package of initiatives, rather than accepting any one as a panacea for all emerging market currency mismatches.

1. Create an independent Financial Stability Agency—a centralized monitoring and reporting agency that recommends to the International Monetary Fund (IMF), World Bank or other multilateral agencies interventions in countries that show widening currency mismatches or other weakening financial stability leading indicators.

Despite the positive reforms suggested for IMF operations, the Fund faces an uphill battle in convincing emergency finance recipients—many now hostile towards the IMF—that its recommendations on financial stability will become more adaptive to the needs of emerging markets and stress impartiality.[27] Due to a lack of segregation between reporting vulnerabilities and providing emergency finance, the IMF and other international financial institutions risk accusations of being too interventionist in a country's economic affairs. To promote an environment of impartiality, an independent financial agency could be set up to define, monitor and report financial vulnerabilities. This would remove the reporting function from the IMF's lending activities, allowing the Fund to concentrate on more appropriate financing packages that can adapt to changing needs and fluctuating capacities of borrowers over the life of a loan. The agency might even be established separately, so that voting shares might favour emerging market countries, addressing the common if unproven criticism that the IMF policies favour G-7 countries. With a greater say as gamekeepers of financial stability in an independent agency, emerging market countries critical of the IMF may feel compelled to support these essentially positive reforms.

The role of the independently-constituted agency would include publishing reports on financial stability and ensure indicators are relevant and calculated in an unbiased fashion. They would regularly publish a broad range of easily-monitored measures such as the AECM, among others, and highlight issues where data from specific countries may be subject to dispute. The agency would submit recommendations to the IMF and other multilateral agencies, but take no part in provision of finance. Where financial vulnerabilities are noted, agency recommendations would ensure much earlier interventions. For this to be effective, the agency would need to tread a fine line between regular and special pre-emptive reporting, which could spook financial markets and exacerbate vulnerabilities. This clearly is no easy task.

A key agency function would be to distil accurate indicators from multiple sources and critically examine data input from national sources. It would also offer technical assistance to countries to enhance financial reporting. Over time this would result in more homogenized data collection. Key indicators could also draw on the work of one or more international financial institution, financial market practitioners or the Bank for International Settlements (for banking and finance indicators). Creating an independent agency would reduce any perceived conflicts of interest with the other functions of international financial institutions.

2. Establish multilateral debt covenants, or use other means, to help reduce a currency mismatch within the financing package itself, such as performance criteria contingent on progress in developing local currency financing alternatives.

A key criticism of the IMF and other financial institutions is that they offer inappropriate financing packages for countries that need assistance. Domestic currency financing should be a key part of any package because the lender can assume the currency risk and use its credit rating to mitigate risks. But even US dollar loan packages would be beneficial if conditional covenants are attached that address currency mismatches. Financing packages could include quantitative incentives (e.g., if a specified percentage growth in local currency bond markets as a percentage of GDP, or net substitution of external debt for domestic debt is achieved, then a rebate results) or qualitative incentives (e.g., a rebate would be received upon successful government issuance of a 20-year local currency bond to extend the yield curve).

3. In economies where local currency debt markets have not developed because of poor inflation track records, encourage governments to issue inflation-indexed securities as a first step towards local currency bond market development.

As inflation-indexed bonds by themselves can lead to the entrenchment of inflation within a financial system, this measure needs to be considered within a package of anti-inflationary policies. Otherwise, local currency debt products will not develop beyond inflation-adjusted instruments. Over-reliance on long-term debt instruments linked to short-term events such as inflation may have the undesirable benefit of creating a "virtual" long-term debt market—one that has practical hazards as the bedrock for infrastructure finance.

4. Urge international financial intermediaries to become active market participants in derivative products that result in the importation of pricing efficiencies from developed to emerging markets.

When a market reaches a certain stage of development, efficiency gains become apparent from derivative products for unbundling and allocating risk (Luengnaruemitchai and Ong 2005). Encouraging the growth of hedging mechanisms priced off of liquid and deep international markets should be a stated policy of international financial institutions.[28] They have a key role to play as most industrial countries and private corporations only have a passing interest in promoting price efficiency in developing markets. While financial efficiency is first and foremost a country concern, the presence of an international financial institution as a powerful counter-party can facilitate the actions of the country in creating efficient price transference mechanisms. As constant participants in swap and other derivative markets leveraging off their own high credit ratings, they act as agents for importing price efficiency.

5. Encourage multilateral development agencies to issue local currency bonds through non-traditional distribution channels.

It is not enough to simply issue a bond to borrow and lend proceeds in an emerging market's currency. The effects are too temporary with the benefits too illusory. International financial intermediaries should also explore issuance through non-traditional pathways instead of using standard underwriting arrangements.

6. Create an economically integrated market place—another possible pathway to financial stability—with the final output being the creation of a single regional currency.

Emerging economies aligned through close economic ties or trade-flow dependency could consider entering into similar arrangements to the European exchange rate mechanism. Linked regional currencies can provide a measure of protection against localized currency vulnerability. If successful, a zone of monetary stability protects economies from volatility introduced from outside the region. The final goal would be a single regional currency. This calls for a staged development based on defining and recognizing major current and potential future barriers to monetary integration. A secondary concern is the issue of what constitutes an optimal currency zone. Depending on the conceptual integration road map agreed upon; a development timetable and implementation strategy needs to be formulated.

As Europe showed, economic integration is not without risks. At the intermediate stage of currency convergence, the currency problems of one country immediately become the problems of related countries, particularly as market participants look to determine the relative values of each component currency within the chosen exchange rate development pathway.[29] Currency mismatches become an aggregate problem—the currency grouping is viewed to be only as strong as its weakest member. Any currency reform agenda should flag the period when the risk of currency vulnerability is highest and take steps to ensure that the period is as short as possible.[30]

The Asian Development Bank is examining the viability of initiatives that strengthen financial ties between East Asian economies, ultimately leading to greater economic integration.[31] In its early stages initiatives could include unifying the clearing and settlement systems within the region and encouraging uniform investment tax codes across all participating countries. So far the impetus has been the ASEAN+3 governments, but the concept could widen to include South Asia or the Pacific. In May 2006 the Ministries of Finance of the People's Republic of China, Japan and the Republic of Korea, agreed to co-operate on further research on a regional currency unit.

Currency initiatives that leverage off trade and foreign direct investment fundamentals seem to promise more long-term success than proposals for a very generalized emerging market index (Eichengreen and Hausmann 2003). For example, the World Bank and other multilateral institutions would issue debt denominated in an emerging market index currency and would swap their currency exposures with countries whose currencies were included in the index. Loan and reserve swaps, while powerful, are limited in scope. The drawback is that they concentrate on the government and the multilateral sector, ignoring the existence of markets for many of the essential components of the index. There is an implicit assumption that the usefulness of the arrangement to the public sector will automatically ensure a private sector buy-in. In reality trade and portfolio flows tend to be a much stronger base for any currency reform, because they are multi-sector and create a compelling reason for the private sector to become an early participant. The lack of an underlying commercial basis for an emerging market index may argue against its long-term practicality for anything other than being a reserve management tool.[32] If a currency basket fails to perform the services of money, then it seems unlikely that any currency basket product, no matter how cleverly engineered, is likely to find a market niche (Levich 1987).[33]

The simple fact is that by implementing several of these recommendations, the behaviour of both emerging market countries and the international financial institutions will substantially change. International financial institutions become more proactive with interventions to ensure financial stability occurring much earlier.

Costs and benefits

There is a minor net cost to most monitoring and implementation measures because international financial institutions and other groups such as the Bank for International Settlements have already prepared—and continue to prepare—many of essential indicators. Even an agency cost of $100 million a year for monitoring and control—an estimate admittedly plucked from the air—is insignificant compared with the cost of contagion. The major stumbling block to implementation might actually be in resolving "territorial" issues on behalf of competing multilateral agencies.

There also needs to be a shift from the "reporting to please" tendency of IFI's to one of "here's a problem, let's fix it." There is absolutely no cost to this initiative, though it might take time to break habits developed over the past decade or so. Early warning systems, for example, need to be applied uniformly once specific leading indicators and their thresholds have been defined for each participating economy across a region.

In terms of the costs of crises it is interesting to compare the first direct cost estimates of control with some measure of total cost. Early IMF estimates of necessary fiscal adjustments put the costs of financial market restructuring in Asia in 1997 from 1% of GDP in Indonesia to 3% of GDP in Thailand, most of which was done by reducing public investment in projects with low economic returns (Fischer 1998).[34] Obviously, 3% of GDP is substantial, but it doesn't come close to estimating the total effect of contagion both inside and outside the financial sector. The IMF has noted that the severity of the restructuring programmes was because of late requests for assistance—when plummeting currency values continued unabated leaving reserves perilously low. A more proactive monitoring and reporting approach may not have avoided the crisis, but it could have helped reduce its cost. This is especially true if interventions had occurred earlier, and as a result of honest assessments from agencies and other international financial institutions.

Studies have attempted to estimate the "total" cost of crises. Most concentrate on changes to output in affected countries or a variant thereof. During the 1990s, the global cost was estimated to be between \$107 billion a year (Eichengreen, Kletzer and Mody 2004) and \$150 billion a year (Griffith-Jones and Gottschalk 2004). The cost is invariably underestimated for several reasons. Output changes in countries outside of the immediate crisis-affected regions tend to be excluded.[35] Coming up with enormous numbers for the cost of crises also tends to desensitize observers to the human cost. The effects of crises on social development such as education and health services are impossible to measure, as they can take years to filter into the financial system.[36] Total output figures in the billions and trillions of dollars make little sense to the poor in crisis-affected regions who live below the poverty line of \$2 a day. Often these are the majority of crisis victims, and there are few safety nets available.

Notes

1. See particularly Cornia (2001, chapter 5). Although contagion tends to be regional or sector-specific, the resulting financial crises have ramifications across borders and in trade, poverty and education.
2. The 1992 exchange rate mechanism crisis and the 1987 Wall Street crash tells us it is not only emerging markets that lack financial stability.
3. In many arguments on emerging market currency mismatches, a large part of the analysis addresses the need for financing in local currency. Often neglected is the need for local investors to shift savings offshore because of the lack of investment opportunities onshore. A good example is the Philippines where investors, particularly banks, buy US dollar-denominated international bonds issued by Filipino corporations because of the absence of a well-functioning local currency corporate debt market. During currency crises these investments do not tend to be repatriated because they provide a protective currency hedge against further devaluation for the investor.

4. Bonds that do not trade are unreliable when creating a credit curve. Rather, a regular trading history and liquidity are essential preconditions to the process.
5. For more information on the tenets of issuance, see World Bank (2005, p. 78).
6. See www.asianbondsonline.adb.org.
7. A collective action clause (CAC) allows a majority of bondholders to agree on a debt restructuring proposal, legally binding on all holders of the bond, including those who vote against the restructuring. They enable easier agreement among bondholders, and reduce the power of "rogue" investors who might seek to derail a restructuring proposal.
8. Proponents of original sin include Eichengreen and Hausmann (1999).
9. Where offshore investment was specifically prohibited, these balances tend to be invested in short-term assets, effectively ensuring that they are not an available source of long-term funding for infrastructure. The end result is effectively the same: capital is not mobilized.
10. Dependency on one pool of finance is a condition that most corporations attempt to avoid.
11. A notable shortfall is the fact that investment capital outflow from an economy is netted against foreign currency liabilities. See also Goldstein and Turner (2004).
12. The Vietnamese dong did in fact go through a "managed" devaluation due to a number of other factors.
13. Debt securities with longer maturities may have their coupons reset with reference to a short-term reference rate. Although the debt obligation is long term, the interest rate exposure is linked to the volatility of a short-term instrument. Instruments of this type are popular where the inflationary outlook tends to be uncertain.
14. AsianBondsOnline
15. Asia Bond Monitor issue 4 see box
16. Mohanty and Turner (2004), among others, have raised this objection.
17. The demise of the hedge fund, Long-Term Capital Management (LTCM), and its effect on the international capital markets is a prime example.
18. Under this approach, countries might have formal trade sanctions slapped on them because of trade stock being dumped on an unsuspecting consumer yet escape sanctions for long-term currency manipulation

because the sovereign is allowed to determine the exchange rate with impunity.

19. Bank for International Settlements background data for AECM measurements.

20. See note 4.

21. The IMF is not limiting its action plan to emerging markets but also addressing the need for structural reform in Europe and fiscal adjustment and measures to stimulate private savings in the US. See de Rato (2006).

22. Fisher admitted that the severity of IMF actions in Asia in 1998 was due to the lateness of the intervention.

23. The G-7 consists of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

24. See *Wall Street Journal* Asia Edition, Volume XXX, no. 161, page 1. In South Korea in 1998, the IMF was colloquially referred to as "I am fired," while Argentina's repayment of the fund was greeted by celebrating Argentineans who released of balloons with "Ciao IMF" emblazoned on them.

25. In the case of the AECM, the actions to reduce the mismatch are known. So are the potential associated risks from these actions. A pragmatic and flexible approach to data computation would ensure that sub-indicators might be included to analyse these contingent risks.

26. See particularly the issuance of inflation-indexed bonds, which are long term instruments with coupons dependent on a short term variable. Refer to footnote 12.

27. No judgement is made on the correctness of specific criticisms of the IMF. The ambitious reform program undertaken by the Fund might be well served by the creation of such an agency.

28. According to Burger and Warnock (2003), the development of local currency bond markets and the concomitant development of derivative instruments should encourage global investors to place funds in emerging markets. Global investors are generally more willing to assume risks if they have access to hedging facilities that will allow them to shift that risk when deemed appropriate. The relationship between the development of underlying cash markets and derivatives is complex.

29. The intermediate stage of currency convergence is usually when the currency bands are being determined but exchange rates are not fixed, and monetary policies are not uniform across the region.

30. Eichengreen (2004b) provides an excellent discussion of the various pathways towards a single currency. He differentiates between the

European approach, a political solution and the parallel approach, more economically rationalist. Depending on the strategy chosen, the risks of a currency crisis are likely to occur at different times in the process towards a single currency.

31. The Asian Development Bank created the Office of Regional Economic Integration (directly under the Office of the President) in 2005.

32. Limited applicability was one of several reasons why the special drawing rights arrangements lost favour.

33. Levich (1987) made this point regarding the European Currency Unit, the precursor of the euro. The point is valid for any currency basket arrangement.

34. Curtailing projects on the basis of low economic returns invariably punishes the social agenda.

35. For instance, the GDP growth of Australia and Pacific countries was affected by a slowdown in the economies of their major trading partners in Asia.

36. Cornia (2001) investigates the consequences of a financial slowdown on employment in an emerging market economy.

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The IMF as the Principal Institution for Promoting the Global Public Good of Financial Stability

4 Chapter

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Avoiding degrees of financial instability that adversely affect economic and social well-being is accepted as a public good. Avoiding spillovers of financial instability between countries and addressing global financial system issues is a global public good. Financial instability has several dimensions. Taking a broad definition—including macroeconomic instability, events that originate in developed as well as developing countries and actions to prevent or handle financial crises—the International Monetary Fund (IMF) has a good claim to be considered the principal institution for promoting global financial stability, although that is not its only function. At the same time it does and must operate within a network of other institutions and groups, with which it must cooperate to be effective.

Compared with other international institutions, the IMF has many strengths: professionalism, flexibility, responsiveness, governance and legitimacy. This assessment of the IMF's strengths and weaknesses as the principal institution for promoting financial stability identifies some gaps in current arrangements and issues that will require attention if the Fund is to retain its past strengths and adapt to a changing role and changing expectations. It also identifies several—in some cases very tentative—proposals for improvement.

A brief discussion of other apparent gaps in global governance in this area, going beyond the IMF, suggests some further issues that need attention. They include risks emanating from institutions and markets in developed countries (such as the potential impact of a collapse of a major global financial conglomerate) and possible new roles for the IMF if it is to strengthen its role as the principal institution responsible for global financial stability.

The proposals are presented not as a blueprint, but more as an indication of the nature of changes needed to match the IMF's governance structures to the economic realities and emerging governance practices of the twenty-first century. Taken as a package, they should not increase costs. There would, for example, be savings from the suggested changes to the governance structure. But if there

were to be further increases in the Fund's operating budget or a sustained loss of income resulting from lower lending, consideration should be given to making better use of Fund resources currently invested in gold, rather than loading more costs onto lending charges to members.

This assessment could cover a wide set of issues, from monetary and fiscal policy in the United States to the technical operation of international payments systems, or from debt restructuring in Argentina to what might be perceived as harmful tax practices in a small island state. The approach taken is to seek to focus on what appear to be the key policy issues.

The second section, after this introduction, discusses the dimensions of financial stability as a global public good that are or should be receiving attention. It takes a broad view of the components of financial stability, consistent with the view taken hitherto by the International Task Force on Global Public Goods. The third section briefly reviews the principal international institutions, networks and groups dealing with financial stability issues. It concludes that the IMF has a good claim to be the principal global institution for promoting financial stability, but that it does and must operate within a network of other institutions and groups, with which it must cooperate to be effective. In some key areas it may need to develop its role further. The fourth section assesses the IMF's strengths and weaknesses in fulfilling this role. It takes account of a wide range of recent criticisms and proposals but is not exhaustive. It identifies key issues for attention and proposals for improvement. The fifth section discusses other apparent gaps in global governance beyond the IMF, suggesting issues that need further attention. And the last section summarizes the main recommendations.

Dimensions of financial stability as a global public good

Complete financial stability everywhere is not a public good: indeed, some instability and risk-taking is clearly desirable. What is usually meant by the public good of financial stability is avoiding degrees of instability that adversely affect economic and social well-being. The global public good of financial stability includes global aspects—avoiding negative international spillovers between countries—from instabilities arising from:

- Macroeconomic policy decisions, particularly as manifested in price or exchange rate stability. This obviously includes issues of interaction between national policies. At the international level, avoiding and handling this instability can involve information sharing between parties, and possibly coordinated actions.
- Failures in the regulation of financial markets and institutions and the framework in which they operate. Objectives, at both the national and international levels, include ensuring smooth functioning of the financial payments system even when under stress (as after 9/11 or the 1987 stock market crash) and a degree of stability in asset prices and financial institutions. Achieving these objectives extends beyond the regulation of financial institutions and markets. It covers other key aspects of financial infrastructure such as accounting and auditing standards, corporate governance and insolvency regimes. Setting and achieving minimum standards in such areas is in itself a public good.

As Goldstein's "The International Financial Architecture and the Emerging Economies" in this volume has pointed out, many recent financial crises have involved interactions between these two areas: unsustainable exchange rate policies combined with failures in financial regulation that have left financial systems or corporate sectors seriously exposed to currency risk.

It is also possible to distinguish between truly systemic issues—such as damaging instability between the major currencies or global payments system issues—and those with a more local origin that threaten transnational consequences.

For all these issues there are two categories of public good: actions to prevent financial crises and actions to manage and mitigate the effects of financial crises when they occur. In considering different global institutions and groups it is useful to distinguish between these two functions, and also between two categories of crises:

- Those that have their origins in actions in developed country governments or institutions. Examples include handling the consequences of price or exchange or interest rate instability arising from poor policies in a major economy; or handling the failure of a major global financial conglomerate institution.
- Those that have their origins in actions of emerging market governments and institutions, such as the 1997/98 financial crises in East Asia and elsewhere.

The task of promoting global financial stability is considered by many to also include addressing other issues that threaten the integrity of the global financial system, including action against money laundering, terrorist financing and global tax evasion.

Key global organizations, institutions and networks handling financial stability issues

Global public goods do not always require an international organization, and this is true of financial stability, where many issues are handled by networks of national public agencies (see box 4.1).

Among these groups and institutions, is the IMF generally accepted as the principal institution for global financial stability? Certainly IMF managers see this as their role. "The IMF's mandate has not changed over the last 60 years. Our chief goal remains that of promoting global financial stability, and thereby laying the groundwork for sustained growth" (Augustin Carstens, Deputy Managing Director, July 2004). But, as discussed below, "financial stability" gets no mention in the IMF's "purposes" in its Articles of Agreement. The Fund's role covers most, though perhaps not all, of the broad range of components needed to deliver global financial stability. Several other factors strengthen the IMF's claim to be considered the foremost among global institutions in this area: its status as an operational institution rather than a club or group, its near universal membership, its demonstrated willingness to take on new tasks and the quality of its work.

The following paragraphs examine the IMF's role in each of the key areas for promoting financial stability. While it does not itself take the lead in every area, and in some key areas appears to be less involved than it should be, its coordinating and overview roles probably make the IMF the principal institution promoting global financial stability. But its role can be understood and assessed only within the framework of other relevant organizations and groups.

Surveillance of macroeconomic and exchange rate policies

The IMF has a historic role in surveillance of members' macroeconomic and exchange rate policies. It also has a function of surveillance of policies in individual countries and a multilateral surveillance function—the twice-yearly *World Economic Outlook* with related discussion in the In-

Box 4.1 Principal international institutions and groups handling aspects of global financial stability

- Bank for International Settlements—the central bankers' club, created before the Second World War. In recent years membership has been broadened to include several emerging market countries.
- International Monetary Fund (and World Bank)—created in 1944, with near universal membership since the collapse of the former Soviet Union. Also two associated Ministerial steering committees, each meeting twice a year—the International Monetary and Finance Committee (IMFC) and the Development Committee.
- Organisation for Economic Co-operation and Development—formed after the Second World War. Also the group of developed country finance ministry and central bank deputies who meet regularly in the OECD Working Party on International Cooperation (WP3). Plays an important role in surveillance of developed economies. (It also has been handling global tax issues and is a leading partner in the recently created Global Tax Forum.)
- Paris Club—club of official creditors, created in 1956 for rescheduling debts of countries that cannot repay on time.
- G-10—the 11 industrial countries (including Switzerland) that are parties to the General Agreement to Borrow (GAB), initially established in 1961 to lend to the IMF if it does not have sufficient liquidity. The agreement was supplemented in 1996 with a parallel agreement with a larger group of countries, including some emerging market countries in the New Arrangements to Borrow (NAB).
- G-5, G-7, G-8—the G-5 (finance ministers and governors of France, Germany, Japan, the United Kingdom and the United States) was established in the mid-1970s to discuss exchange rate issues. It was superseded in the mid-1980s by the G-7 linked to the group of heads of government that started meeting in 1975, and that since 1994 has met as the G-8, including Russia. The early focus of discussions was on exchange rates and economic policy coordination. A more recent focus has been on the global financial stability agenda and role of the international financial institutions.
- Basel Committee on Banking Supervision—the club of banking regulators created to address gaps in global banking regulation revealed by the Herstatt Bank collapse in 1974. Serviced by BIS, but most national regulators are now not central banks. The BIS also services the Committee on the Global Financial System—the committee of central bankers that succeeded the former Eurocurrency Standing Committee.
- Groupings of national regulators, including the International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO), the international group of securities regulators, meet regularly and have global memberships.
- The Financial Action Task Force (FATF) at the OECD—created by the G-7 in 1988, but now with much broader membership, to counter money laundering and criminal exploitation of the global financial system.
- G-20—created after the 1999 G-8 summit, as a group of finance ministers and central bank governors from the major emerging market countries as well as the G-7 and Australia. Its agenda covers all key aspects of global financial stability and economic cooperation.
- The Financial Stability Forum (FSF)—created in 1999, explicitly to promote global financial stability. Members include representatives of national authorities responsible for financial stability from the G-7, Australia, the Netherlands, Singapore and Hong Kong, along with representatives of international financial institutions and regulatory bodies. It meets twice a year and is serviced by a small secretariat based at the BIS.

ternational Monetary Finance Committee (IMFC) and the Fund's input to G-7 discussions. It can influence policy in bilateral discussion and the public debate and work through the peer review process, and it has considerable influence in countries that need to borrow or might need to in future. But in recent years it has had little real influence on such policies in major economies, even where they pose a threat to global macroeconomic or financial stability. There is, however, only limited evidence of other groups or institutions—the G-7, G-20 or Organisation for Economic Co-operation and Development (OECD), for example—being more successful in this regard.

Prevention and handling of financial crises

In recent years the IMF has come to play the lead role in one relevant area: preventing and handling crises in emerging markets that could have global implications. In the 1990s it played a leading role in managing financial crises in Brazil, Indonesia, Mexico, the Republic of Korea and Thailand. Since then, at the request of its members it has led the global effort to strengthen financial sector regulation throughout the world—through the IMF/World Bank Financial Sector Assessment Program (FSAP) and reports on countries' adherence to key standards and codes (Reports on the Observance of Standards and Codes, ROSCs). But even in this area it has "subcontracted"—that is, it has recognized that it has no mandate or expertise in many relevant areas and that important parts of the monitoring and crisis management have to be done by other institutions (such as the World Bank and various standards-setting bodies). Moreover in crisis handling its role is best seen as manager in the sense of coordinator—helping countries regain market confidence through policy action, signalling its own approval of these policies with access to IMF finance and coordinating actions by G-7 and other governments where needed (for example, as in Korea) to help resolve crises.

Addressing financial system issues

The IMF has also stepped up its monitoring of financial system developments, with the launch of the twice-yearly Global Financial Stability Report and the creation of a new International Capital Markets Division. But here the Bank for International Settlements (BIS) and the Financial Stability Forum (FSF; with BIS support) are performing parallel functions. Interestingly, at the twice-yearly meetings of the IMF's Ministerial steering committee, the IMFC, the chairman of the FSF, not Fund management, speaks to issues of financial system stability. Moreover, the IMF plays only a minor role in preventing and handling

Box 4.2 Key risks in the international financial system identified by the Bank of England in December 2004

- "Financial intermediaries and investors appear to have continued their search for yield in a wide range of markets, holding positions that could leave them vulnerable to instability in the pattern of global capital flows and exchange rates, credit events or sharper than expected interest rate rises. . . . In the event of an adverse shock, any over-accumulation of exposures from the mispricing of assets may result in an abrupt, and costly, adjustment of balance sheets.
- "Hedge funds continue to experience strong inflows from investors. Given the relatively modest returns on many hedge fund strategies, some are increasing their involvement in less liquid markets. LCFIs [large complex financial institutions] face a number of challenges. . . .
- "Large UK-owned banks have also been active in international financial markets, and their gross inter-bank exposure to foreign owned financial institutions, including LCFIs, is sizeable. This leaves them exposed. . . ."

Source: Bank of England (2004).

crises with global impacts that have their origins in developed countries. In practice such issues have featured little, if at all, in the Fund's surveillance of the major economies, which normally focuses almost exclusively on macroeconomic issues. For example, of the three major risks identified in the December 2004 Bank of England "Financial Stability Review", none was at the centre of IMF attention in its discussions at the time with major countries of their policies (see box 4.2). (None featured with any prominence in the relevant article 4 report on the United Kingdom.)

There may therefore be some gaps in the current arrangements. In principle, any such gaps should be identified by the FSF. But the FSF is not and is unlikely to become an operational body in this respect. And there may well be a role here that the Fund should be playing, at least by broadening its bilateral and multilateral surveillance to give greater emphasis to such issues (as now seems to be proposed, in the April 2006 Medium-Term Strategy proposed by the managing director). In practice, any crises are most likely to be handled by informal groups of major countries' central banks and finance ministries.

The IMF also plays a growing but largely supporting role on global financial issues like money laundering, terrorist financing and harmful tax practices. Some would like the IMF to do more. Others hold that these areas would be better left to other institutions. The right approach, as elsewhere, is that the IMF should rely on other institutions and groups to take the lead where it has only limited expertise but that as the principal institution promoting global financial stability it has a responsibility to contribute where it can easily do so and to assure itself and its members that there is an effective global response to such threats to the integrity of the financial system—and to voice its concerns where there is not.

Strengths and weaknesses of the IMF in promoting financial stability

This section assesses the IMF's strengths and weaknesses against a set of broader criteria relevant to all key institutions responsible for providing global public goods.

Legitimacy and membership

Unlike most other groups and institutions listed in the preceding section, the IMF has the legitimacy of a near universal membership, its founding treaty and articles, its formal governance structure and its membership in the UN family. But weaknesses in its governance already detract from its legitimacy and are likely to do so more in future, as discussed further below.

Mandate, powers, instruments and obligations of members

It is often said that the formal mandate of the IMF is as relevant today as it was 60 years ago. Indeed the deputy managing director quoted earlier suggests the formal mandate covers everything relevant to the goal "of promoting global financial stability". Closer inspection suggests that the formal mandate set out in the articles does not cover all aspects of this role. The mandate was defined at a time when practically all international transactions were current account payments and when regulation of financial institutions was not seen as central to global financial stability. Article 1, which sets out the Fund's "purposes", makes no reference to either issue (see box 4.3). The IMF has had considerable success in recent years in covering such aspects with member countries on a voluntary basis. But the formal mandate and formal obligations of members still do not fully cover all the functions a global institution for financial stability needs to carry out.

In one area the IMF's mandate is very clear: it is required under article 4 to exercise surveillance over countries' exchange rate policies. Equally, the obligations of members to cooperate with such surveillance

Box 4.3 IMF Articles of Agreement: Article 1—Purposes

"The purposes of the International Monetary Fund are:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

"The Fund shall be guided in all its policies and decisions by the purposes set forth in this article."

are reasonably clear. Yet as is accepted in the April 2006 Medium-Term Strategy, surveillance has often not focused sufficiently on exchange rate issues. In addition, the criticism is sometimes made that the Fund has not fully used the powers it has. For example, it has been very reluctant to voice concerns about members' exchange rate policies and has only very rarely exercised its power to send a special mission to investigate an exchange rate problem. The recent evaluation of its engagement in Argentina noted the absence of any serious discussion in the board of exchange rate regimes. Another criticism is that where there are obligations their meaning is sometimes obscure. (See, for example, the obligation to cooperate on reserves policy, as set out in article 8, in box 4.4.)

But in other relevant areas, such as its assessment of countries' observance of standards and codes in financial regulation or money laundering policies, its mandate is less clear—as is the corresponding obligation of members to cooperate. Moreover, while it has jurisdiction in relation to countries' current account flows and restrictions, it has no formal jurisdiction in relation to capital flows (other than archaic provisions in article 6, which also appears to prevent the use of Fund resources to "meet a large . . . outflow of capital"). This is arguably a serious weakness for

Box 4.4 Some relevant extracts from the IMF's Articles of Agreement

Article IV

Section 1. General obligations of members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) Endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) Seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) Follow exchange policies compatible with the undertakings under this section.

Section 3. Surveillance over exchange arrangements

(a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under section 1 of this article.

(b) In order to fulfil its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies.

Article VI

Section 1. Use of the Fund's general resources for capital transfers

(a) A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in section 2 of this article, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.

Section 2. Special provisions for capital transfers

A member shall be entitled to make reserve tranche purchases to meet capital transfers.

Article VIII

Section 7. Obligation to collaborate regarding policies on reserve assets

Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system.

an organization responsible for promoting global financial stability—at a time when there have been pressures for other organizations such as regional and global trade institutions to promote capital account liberalization without an appropriate input from the IMF.

Of course, the IMF's mandate covers more than acting as provider of the global public good of financial stability. Crucially, it includes helping member countries improve their financial and economic stability even when there is no global spillover, including a major continuing role in low-income countries that are of little significance for global stability (but often affected by global instability).

The powers to carry out surveillance and make loans are clearly very relevant to the IMF's role in promoting financial stability, as is the Fund's role in providing technical assistance to members in its areas of expertise. There are weaknesses in all these areas, as discussed below. But while many suggestions have been made for ways to improve these instruments, there has been little appetite among members to agree on additional powers needed to do the job or powers that might realistically be expected to be assigned to the IMF.

Do weaknesses and gaps in the formal mandate and obligations of members matter, and if so should they be changed? So far the IMF has been remarkably successful in adapting its role to changing circumstances without changing its formal mandate, and members have on the whole agreed to cooperate voluntarily, encouraged in some cases with appropriate incentives. But the mandate has been changed when external changes were large enough (for example, on the collapse of the Bretton Woods fixed exchange rate system). It may be time to take a fresh look.

If there were such a review, it would also be sensible to look at the mandates of the World Bank and World Trade Organization (WTO) to ensure proper division of the roles and functions of these three global bodies. It is sometimes claimed that the IMF's remit for surveillance and support of economic growth means it should survey and advise on the complete range of country economic policies. In recent years the Fund has very sensibly opted to rely on such other bodies as the World Bank to survey country policies in structural areas where it has little expertise, even when these areas are critical to financial and macro stability. It has also sought to streamline loan conditionality to focus only on issues critical to macroeconomic stability. According to the April 2006 Medium-Term Strategy, in the future the IMF will focus surveillance more sharply on issues of financial and macroeconomic stability. There have been many reviews of World Bank–IMF cooperation in recent years, with a new review, to be guided by an external committee, launched in April 2006. In practice there is probably already a good working understanding of the two institutions' roles and responsibilities. But it could be useful to clarify and codify this understanding by revisiting their mandates. At the WTO there are long-standing arrangements for handling issues that bridge trade flows and the currency flows to pay for them. Revisiting the Fund's jurisdiction in relation to capital flows, as suggested above, would provide an opportunity to create a similar understanding of the roles of the two institutions in relation to such flows.

Setting the agenda and managing intergovernmental processes

Before turning to the IMF's performance of specific functions, there are two broader potential roles to assess. Is the Fund good at setting the global agenda on financial stability issues? Is it good at managing the intergovernmental processes involved? The two questions are interlinked.

There are cases where the IMF has acted to set the agenda—for example, the proposal in 2002 to create a sovereign debt restructuring mechanism (SDRM; see box 4.5). But in general the IMF has tended to leave agenda setting to other groups, especially the G-7. The board regularly discusses upcoming policy issues, but its input tends to concern only issues internal to the Fund. And where the IMF does formally set the agenda, in most cases it reflects prior discussion and agreement in the G-7.

The strategic agenda for an institution providing global public goods needs to be set by member governments, not by the institution itself—although clearly the institution should provide an input. It would be wrong to expect the executive board as presently constituted to do the job. The question is whether the role could be taken on by a

Box 4.5 Characteristics of a sovereign debt restructuring mechanism

An SDRM provides a legal framework for restructuring foreign debt. It would typically include the following elements:

- Allowing a qualified majority of creditors to reach an agreement that would then be made binding on all creditors that are subject to the restructuring.
- Discouraging creditors from seeking to enhance their position through litigation during the restructuring process.
- Establishing safeguards that give creditors adequate assurances that their interests are being protected during the restructuring process.
- Excluding a specified amount of new financing from the restructuring as a means of inducing new financing (if such exclusion were supported by a qualified majority of creditors).
- Establishing methods of handling and resolving disputes.

group or groups with wider and more representative membership than the G-7. The G-20 is already beginning to take on aspects of the role. Other proposals involve building on the IMFC or the UN Economic and Social Council, or, as proposed by Kenen and others (2004), creating a new body for the purpose, a Council for International Financial and Economic Cooperation. An effective agenda-setting body of this kind needs to meet regularly at both deputy and finance minister levels; to be of manageable size (ideally no more than 15 members); and to be able to put together groups of interested officials from various capitals to develop suggestions when necessary. A reformed, smaller, more strategic board providing a direct link with key national officials (with a correspondingly smaller IMFC, as suggested below) would be well suited to the task.

When, as at present, the agenda is set by external groups such as the G-7, it becomes even more important for the IMF to interact with and help manage the process. Managing intergovernmental processes has not been a strength of the Fund. In many areas, including setting standards, it relies as it should on others—the groups listed in the preceding section—to handle intergovernmental negotiations. But in areas where the IMF is clearly in the lead it has probably done less than other organizations to foster intergovernmental discussion. Consider, for example, the contrast between the way that the OECD conducts multilateral surveillance discussions with national experts in the OECD Working Party on International Cooperation (WP3) and the way the IMF produces the *World Economic Outlook* without any such interaction. Similarly, in its relationship with the G-7, although it takes part in some meetings, the Fund can hardly be described as managing the process. Despite the difficulties, it could probably do more to provide input.

This situation is partly a result of culture and partly perhaps of the feeling that relationships with governments—including the G-7—should be handled through the board or board members. It would not take much to change the IMF's approach. There are already examples of what can be done—for example, the recent creation of a capital markets consultative group. The proposal in the April 2006 Medium-Term Strategy to implement a new multilateral consultation procedure on global economic issues and interactions between the major economies is a further step in the right direction.

Surveillance and monitoring

In assessing the IMF's performance in its surveillance and monitoring role, it is worth emphasizing how large recent changes have been and how much progress has been made in stepping up assessment of member policies on financial sector issues and in increasing transparency in these areas. At the country level, traditional article 4 surveillance of macroeconomic policies and exchange rates has been supplemented with specific assessments of financial sector stability in FSAPs, ROSCs and Financial System Stability Assessments (FSSAs). The Fund's new emphasis on carrying out debt sustainability analyses for member countries is also relevant. And the Fund has constructed its own standards, for use as benchmarks in data and data dissemination, for fiscal transparency and the conduct of monetary policy. At the global level the IMF has stepped up its monitoring of global capital markets and launched the Global Financial Stability Report (GFSR) to complement the *World Economic Outlook* (*WEO*). The quality of surveillance in both traditional and new areas, while not perfect, is generally considered high.

Going forward, several important issues need attention:

- There are concerns that the IMF's new emphasis on financial sector and capital market developments is not being fully internalized in its work. It is not yet fully reflected in the advice given to member countries in the Fund's article 4 surveillance reports. Some refer to a "silo" mentality in the Fund, with staff in country divisions unwilling to draw on the expertise in specialized departments. As noted above, in surveillance of developed countries, there should be more emphasis on assessing financial sector and systemic risks that have their origins in financial institutions or markets based in or regulated by those countries. More generally, the content of surveillance could usefully be strengthened in a variety of ways including providing stronger advice on exchange rate regimes, currency mismatch, debt sustainability and optimum levels of reserves. There are also clear weaknesses in the "peer review" function, as discussed further below.
- There are concerns that the IMF is often not sufficiently candid in the assessments it makes and the advice it gives. The 2004 annual report of the Independent Evaluation Office (IEO) contains an interesting passage on this matter (see box 4.6). This is a complex issue, as the IEO report makes clear.

Box 4.6 Extract from 2004 IEO Annual Report

"[T]he candor of assessments tends to become muted as they are transmitted through the institution. The evaluations of the three Capital Account Crises, Prolonged Use, and Argentina all suggest that, in various ways, candid internal assessments were toned down in staff reports sent to the Board. This tendency may, in part, reflect the tension between the IMF's role as a 'confidential advisor' to the member country and its provision of signals to broader groups, including official sources of financing and private market participants. But other factors leading to a dilution of candor also appear to be at work. In fact, the tendency to lose some candor seems to be quite common, and is not just an issue associated with documents expected to be made public. These three evaluations all indicated that surveillance reports linked closely with programme-related activities were especially unlikely to step back and raise potentially awkward questions. Recent steps to strengthen surveillance are, therefore, welcome, but it remains to be seen whether these changes will be sufficient to transform underlying incentives in favour of greater candor."

Source: IMF (2004a).

The key question is how to communicate the conclusions of surveillance and other assessments to member countries in a way that leads to policy action where it is needed. There is a tension between the confidential adviser approach, which still works well in some cases, and greater transparency, which can influence the national debate and attract market discipline. Maybe the best approach is to combine the two: start with confidential messages, but if they are not heeded proceed to making the Fund's concerns more transparent. Even if this creates an adverse market reaction, it could be less severe than if no policy action were taken. A complementary approach is to construct financial incentives for following IMF advice, including contingent lending facilities for countries that meet standards and codes or conditionality of IMF lending on meeting these standards.

- None of these proposals offers any significant prospect of addressing another critical issue: the IMF's lack of influence over policies of developed countries, including the major countries whose policies have such a large impact on global financial stability. Here the best approach may be to try to strengthen the multilateral surveillance process, using the G-7 or similar groups to apply peer pressure. But this will require stronger efforts by the Fund to interact with such groups and deliver messages effectively. The proposal in the April 2006 Medium-Term Strategy, noted above, could be a move in this direction: much will depend on how, and how effectively, it is implemented.

- The IMF has had to rely on the voluntary cooperation of members in implementing its new financial sector and stability assessments (FSAPs, ROSCs and FSSAs). Most members have cooperated. In 2004 FSAPs had been carried out, were under way or were planned in 97 countries (for details see the October 2004 Issues Note for the IEO Evaluation of the FSAP). By September 2004, 581 ROSC modules had been completed in more than 90 countries, of which 481 had been published. Although no country refused to cooperate, several have successfully delayed assessments. (In the case of G-7 countries, by the end of 2005 all except one—the United States—were subject to the FSAP. Among key emerging market countries, there had yet to be an assessment of China.) It would clearly be a serious matter if the IMF had to delay making an assessment in a case where there appeared to be a significant risk to global financial stability. This raises the question of whether greater incentives for cooperation can be devised or whether the formal obligations of members should be reviewed.
- Another issue is how to handle interactions with standards-setting institutions, where tensions arise when monitoring reveals weaknesses. This is one aspect of a larger issue discussed below—the Fund's need to give more emphasis to working and cooperating better with other institutions as it carries out its functions.

The UK Treasury has made a radical proposal to address some of these concerns (Balls 2003). It noted the tendency of IMF staff to tone down surveillance messages, the tendency of the board to do the same (since directors know that one of the countries they represent may be next to be criticized) and internal conflicts of interest particularly in cases where there is a lending/programme relationship. It suggested a complete separation of the IMF's surveillance and lending functions, with the board effectively removed from the surveillance process. There have been some small moves in this direction, with the introduction in the Fund of the idea of introducing "a fresh pair of eyes" in surveillance. In April 2006 the IMFC agreed that it would "set a new annual remit for both bilateral and multilateral surveillance through which the managing director, the executive board and the staff are accountable for the quality of surveillance" and that this "should involve the independence of Fund surveillance, greater transparency and the

Independent Evaluation Office". The broader proposal remains on the table and is discussed below in the section on IMF governance.

Technical assistance and capacity building

Surveillance, monitoring and assessment is of course only a first step in the process of strengthening country systems to make them less vulnerable to financial instability. Their impact depends on follow-up where surveillance reveals weaknesses in national financial systems. In developed countries this is something that can be left to the countries themselves, with the IMF checking that remedial action has been taken, and where necessary suggesting further action, in follow-up assessments and monitoring. But many developing countries need help and support with the relevant capacity building.

The IMF has only limited relevant expertise and limited resources to finance advice and technical assistance. Should these resources be increased? A better approach would be for the Fund cooperate with other institutions, such as the World Bank, that have more experience and greater comparative advantage in managing and providing technical assistance, with the Fund focusing on identifying gaps and acting as a catalyst.

At a minimum, however, the IMF should do more to monitor follow-up actions when it has identified weaknesses and act as a catalyst for extra technical assistance from bilateral donors and multilateral development banks where needed. Filling any gaps that remain would then be a sensible use of the Fund's budget for technical assistance.

In some cases there may be a parallel need for longer term financing to help countries build capacity to reduce their vulnerability to crises, and a proposal has been made for a new long-term IMF facility for this purpose. The direct financing needs for building capacity—for example, building banking supervisory regimes—are not large, and if needed bilateral donors or multilateral development banks can provide the finance through grants or loans. The argument for a long-term facility is that while they are building capacity countries would often do well to reduce their reliance on potentially volatile market finance and borrow more medium-term money from stable official sources. The IMF can and should advise on the need for such financing and should be better placed to do so as it develops its country-by-country debt sustainability analyses. But providing medium-term finance is not within the Fund's mandate or area of expertise. It seems much more within the remit of the multilateral development banks, which could link substantial programmatic loans, where needed, to desired capacity building and policy reform.

Crisis management and financing

In 2003 the IEO published an evaluation of the IMF's role in the capital account crises of the late 1990s in Indonesia, Korea and Brazil. In 2004 it published an evaluation of the role of the IMF in Argentina between 1991 and 2001. The conclusions and recommendations from these evaluations are highly pertinent, and it is worth repeating and elaborating on some of the key conclusions:

- Policy programmes devised by the IMF had become too elaborate. In a crisis governments should focus on those actions essential for resolving the crisis. However desirable, other longer term reforms should not normally be made conditions of crisis resolution programmes. Policy advice and conditions should focus on actions directly relevant to crisis resolution.
- Where a collective action problem affects the behaviour of financial institutions based in developed countries—as proved to be the case in Korea—the IMF should take the lead, sooner, in working with developed country governments and banking authorities to address the issue. (In Korea the vast majority of exposed banks proved ready to roll over their loans once they were assured that other banks would do the same.)
- After allowing for such action—and, in some cases, necessary private sector debt standstills and restructuring—total financing provided must be adequate. Where part of the financing is provided in parallel to the IMF it must be real (unlike the parallel bilateral financing announced in the Korean case, which proved to be largely window dressing) and must support the policy framework agreed with the IMF.
- From the Argentina experience, the IEO emphasized that the IMF should have a contingency strategy from the outset of a crisis, including "stop-loss rules"—that is, a set of criteria to determine whether the initial strategy is working and to guide the decision on when a change in approach is needed.

The conclusion that the IMF should take the lead in dealing with collective action problems provokes a crucial question: what is the appropriate balance in a crisis between official financing and financing/financial loss by private lenders and investors? The argument for greater official financing is essentially the same as the argument for a national lender of last resort providing finance in a pure liquidity confidence crisis. But pure liquidity crises are rare, and it is hard to know in advance whether a liquidity crisis will turn out to be a solvency crisis—and unlike domestic central banks, the IMF cannot be sure that in the last resort member governments will make good any losses. The argument for less official finance is that large-scale lending in a crisis gives the wrong message to private lenders and investors—in effect, encouraging them to take risks that they would not take if they thought a bail-out less certain. In recent years IMF access policy has been tightened significantly in recognition of this argument—although it has yet to be seen whether access will in practice be restricted in the case of a crisis in a major country.

Logically, restricting official finance for crises should go together with action to provide for more orderly restructuring of private sector debts. Some useful steps have been taken. The widespread inclusion of so called "collective action clauses" in bond contracts (about 40% of emerging market bonds on issue now have such clauses) makes it possible for a majority of bond holders to agree to restructuring as an alternative to default. Also, some progress has been made in the G-20 in distilling some "principles" for a code of conduct for debt negotiations involving private sector creditors and investors. But the key proposal in this area, the IMF's proposal for an SDRM (see box 4.5) has had to be shelved for lack of support.

Should the SDRM proposal be revisited? In practice much depends on what major countries believe their legislatures will accept. But from the point of view of promoting global financial stability the best approach would probably combine two elements. First, access limits should be retained but increased somewhat from their current levels, with an explicit recognition that because capital account vulnerability is not a factor in the quota calculation countries particularly exposed to capital flows may need exceptional access. This higher access could be partly achieved, and financed, by an overall increase in IMF quotas. Second, this move should go hand in hand with a clear understanding that on some occasions countries will not meet all their debts or will need to impose debt standstills, and on others parallel action will be required to address collective action problems among private investors (with the existence of collective action clauses being helpful in this respect). It may well be sensible to revisit the question of formal mechanisms and procedures for orderly debt restructurings, after a period of experience with a combination of the new exceptional access framework, the wider adoption of collective action clauses and agreed voluntary principles and practices for debt restructurings.

There are three other issues to address under the heading of financing facilities. The first is the proposal for the IMF to further issue Special Drawing Rights (SDRs) to member countries. SDRs are not free money: they are what the name implies—rights to draw on the IMF—and when drawings are made interest accrues. Since the drawings can be made at will they are in effect an unconditional lending facility. The IMF articles provide for an issue if there is a global shortage of liquid assets—scarcely the case at present. While there may be a case for a quota increase, to permit greater conditional access to Fund finance, there seems little or no case for an SDR issue.

The second issue is the potential role of regional monetary funds to complement the IMF, particularly in financing crises. Since there may be greater willingness to provide financing to regional neighbours, such funds could well provide additional finance—as, indeed, do existing swap mechanisms between central banks in some regions. But experience shows that such regional bodies are poor enforcers of conditionality: political links between the countries involved are too strong and multifaceted. The answer perhaps is the one implied by the IEO. Regional funds could usefully supplement IMF finance, as long as the finance supports the policy framework agreed with the IMF (and is real, not mere window dressing).

Third, there is the question of how to replace the Fund's Contingent Credit Lines (CCLs). It was established to provide near automatic access to IMF lending in a crisis for countries that met certain minimum policy standards. The idea is to give additional incentive to strengthening policies and frameworks for financial stability. But no country has applied. The underlying idea is sensible enough. The April 2006 Medium-Term Strategy includes a proposal for a new facility to meet the same needs as the CCLs, but with different modalities. One way forward would be to make access to this new facility automatic for countries that are declared eligible by the IMF. (There would be no need to apply, and some—initially perhaps only a few—middle-income counties and most, but perhaps not all, developed countries could be declared eligible.) After each article 4 consultation the board could decide, on the recommendation of Fund management, whether a country's policies met the standards. This would give the IMF a new "signalling" role that some would not welcome and that staff and management might be reluctant to take on. But if carried out professionally and competently, such a signalling function could be an additional benefit from the proposal, not a disadvantage.

Expertise and culture

Historically the IMF's principal expertise has been in macroeconomic policy—the focus of its formal mandate. The principal institution for global financial stability requires expertise in other areas and sufficient knowledge across an even broader area (extending to such issues as corporate governance or insolvency law) to know when to bring in outside expertise. The Fund has strengthened its expertise in some other relevant areas, notably banking regulation. It has also acted to strengthen its knowledge of and links with private financial markets.

The IMF's culture of adapting quickly to new and changing roles has been helpful in this regard. Less so has been its willingness on occasion to take on tasks in new areas where it has little or no relevant expertise. In such areas it often accepts that it has to rely on other institutions (as in securities market regulation, insurance, corporate governance, insolvency). But this requires methods of working in partnership that are new to the Fund's culture—a culture developed in an institution that in the past has worked in a narrower field, macroeconomic policy, where it has had to act quickly and decisively in ways that leave little scope for consulting and cooperating with others. Too often in practice it has sought to build its expertise in areas where it should rely on others. It has been particularly reluctant to take advice and help in its surveillance activities—partly it seems on legal grounds, compounded by a tendency to give too little central guidance on the IMF's strategic priorities and what should be the limits to its role.

The nature of the financial stability function makes a willingness and ability to cooperate with and rely on other institutions and groups, using their judgement and expertise, crucial to the IMF's effectiveness. Its history of working largely alone in a single area—macroeconomic policy—means management must make a deliberate and sustained effort to bring about the needed change in culture.

Box 4.7 Extract from 2004 IEO Annual Report

"*Need for Greater Clarity about Intermediate Objectives*

"The ultimate objectives of the IMF are clearly set out in the Articles of Agreement. However, many IEO evaluations indicate that the more immediate specific objectives to be achieved by particular initiatives, from which one could derive the criteria by which the effectiveness of the institution's contribution is to be judged, are often quite vague. . . . This lack of clear goal posts for what the institution is trying to achieve with certain initiatives, and the dearth of performance indicators to track progress against those criteria, is not unique to the IMF [but]…it has substantive implications for the effectiveness of the institution, including priority-setting and accountability. IEO evaluations suggest that the frequent lack of specificity about intermediate objectives and deliverables has contributed to several problems:

- *A tendency to 'over-promise' on what the IMF can deliver. . . .* More generally, vagueness about intermediate objectives makes it harder for the institution to say 'no' on the grounds that some issues go beyond its comparative advantage.
- *Lack of prioritization.* Because objectives are set in very general terms, it is hard to specify clear trade-offs between various components. . . . If the objectives of a programme or project are not indicated, it is difficult to evaluate whether it is succeeding or failing.
- *Profusion of internal guidelines*, which cannot replace more effective priority-setting.
- *Overstretching of IMF staff.*
- The result of this overstretching was an *ad hoc approach to solving trade-offs between priorities. . . .*
- The *'broad tent' nature of some objectives can lead to 'mission creep' . . .* or to a lack of clarity about precisely how the IMF's role fits into a broader partnership framework.
- *Difficulty in assessing the degree of progress and making mid-course corrections.*

Because there is no way to determine when an initiative or activity is falling short, there is a risk of complacency, in the sense of being satisfied as long as some good is being done.

"This concern is now well recognized within the IMF, as reflected in recent initiatives to begin identifying more specific performance indicators to monitor how effectively the Fund is achieving its objectives. The International Monetary and Financial Committee (IMFC) recently endorsed such efforts in calling upon the IMF to develop a methodology for better assessing the effectiveness of surveillance. But the real payoff to such efforts will come when they force the institution to make difficult trade-offs between priorities, with clearer specification of objectives when policy initiatives are introduced. An example of a move toward defining priorities among objectives is the recent conclusion of the biennial surveillance review, which set three priorities as monitorable objectives for the next surveillance review: ensuring deeper treatment of exchange rate issues; enhancing financial sector surveillance; and deepening the coverage of regional and global spillovers in bilateral surveillance."

Source: IMF (2004a).

Management and internal procedures

Changing the IMF's culture in this way, and increasing the staff's understanding of the limits to its knowledge and expertise, is one challenge. But there are others. An organization with the Fund's functions needs to be highly professional; capable of making good, correct judgements on policy weaknesses and where policy adjustments are needed; able to act quickly and decisively, including changing course when initial prescriptions prove inadequate; and ready to learn from experience and adapt to changing circumstances and challenges. These have all been strengths in the past—it will be important to maintain them.

It will be particularly important to protect management's traditional independence in making staff appointments, selecting the best person for the job. A valid criticism of past appointments is that there has been too much focus on recruiting people with high academic qualifications, and not enough on recruiting those with hands-on experience of economic and financial administration, particularly from developing countries.

When the IMF was established, the executive board was seen as, to some extent, part of the institution's management. But in recent years, board members have become less independent—more spokespersons for their countries and constituencies—and have given less priority to effective oversight and management. Increasingly, as already noted, the board's detailed engagement in surveillance is eroding its value (in its reluctance to criticize peers). Similarly IEO studies have suggested that board involvement in lending decisions has occasionally introduced (political) considerations that have led to less than optimal outcomes.

Ideas (discussed below) for converting the role of the board to give it more of an oversight function and reduce its involvement in individual decisions would address this issue. But they raise another point that needs attention. A modern management system, with devolved management and only general oversight at the board level, requires measures or benchmarks against which the institution can be held accountable. Devising such measures in areas of IMF activity will not be easy. But the effort needs to be made. Indeed the IMFC has already called for measures to be developed for the Fund's surveillance activity, and as noted above, in April 2006 strengthened this request. Good, qualitative, independent evaluation can also make an important contribution—and the creation of the IEO has been a positive step. The IEO in its latest annual report has some interesting things to say on the issue (see box 4.7).

Governance

An organization that needs to act quickly and decisively on occasion, engender trust in its policy judgements and make arrangements to proceed on the basis of majority voting must have governance arrangements that confer legitimacy. The IMF's governance arrangements are in many respects better than those of other global institutions; there is agreement to proceed by majority voting (so that it can act without unanimity); and the constituency system of representation has been a source of strength. But several governance issues currently under discussion need to be addressed if the institution is to retain the legitimacy it needs.

Selection of the managing director. First, there is a concern about the process for appointing the managing director—by convention, a nominee from a European country. Less often commented on is the parallel process for appointing the first deputy managing director, a post of some power generally treated as an appointment of the US administration. In both cases radical reform must await broader reform of appointments to the heads of a range of agencies—certainly including the World Bank and WTO. There is a good case, for example, for taking the selection process out of the hands of member governments and charging an international group of appointed "wise men" with identifying a range of candidates and appointing the best person for the job, regardless of nationality. But some more modest changes might be made to IMF processes that would give greater confidence in selecting candidates of the highest quality while also modestly increasing the voice of the broader membership in the process. For example, European countries and the United States might be expected to nominate three or four well qualified candidates, with the final choice made by the entire membership. The April 2006 Medium-Term Strategy calls for more transparent guidelines on the selection of the managing director, and that would be a useful first step.

Voting shares. Second, and perhaps more important, there is now wide recognition of the need to adjust members' voting shares to reflect current economic realities, if the IMF is to retain legitimacy. The relative sizes of economies—which seems generally accepted as key in deciding voting shares—suggests there should now be a substantial increase in voting shares of many emerging market countries, mainly at the expense of European voting shares. Many proposals have been made for ways to achieve this reform. Key principles should probably include:

- The main factor in determining voting share should be the size of the economy. As well argued by Buira and others, the best measure to use is GDP measured as Purchasing Power Parity—both less volatile than GDP measured at market exchange rates and a better measure of relative economic weight.
- As in the existing formula, some weight should also be given to each country regardless of its size—perhaps something like

the 10% weight assigned to basic votes at the time of the IMF's creation.

- A much better system is needed for keeping voting shares in line with the size of economies, given prospective changes in the global economy in the next 20 years.
- Countries also need quotas to determine their access to IMF credit. These quotas could continue to parallel voting rights, although this is not absolutely necessary.
- Arrangements are needed to protect the interests of creditors. But protection could be achieved—as it already is if the IMF needs to activate the arrangements to borrow from members under the New Arrangements to Borrow—by requiring special majorities in lending decisions among countries that allow their currencies to be used by the Fund.
- In deciding on access to IMF resources, some account also needs to be taken of a country's openness to global financial flows. But as capital flows dwarf current account flows, it no longer makes sense to rely on a country's trade flows as the measure of openness. It should be dropped from the formula used for calculating quotas and voting shares. Given the difficulty of devising useable measures of capital account vulnerability, it may be best to use this characteristic as a factor in deciding

Table 4.1 Current voting shares and voting shares if determined by PPP GDP

	Voting shares of IMF constituencies led by countries in column 1 (%)	Voting shares if determined by GDP on a PPP basis[a] with a 10% weight for basic country votes (%)
United States	17.14	19.4
European Union	33.65[b]	19.5
China	2.15	10.1
Japan	6.15	7.1
India	2.40	4.0
Brazil	2.47	2.5
Russian Federation	2.75	2.3
Canada	3.72	1.8
All developed countries	63.3	49.7
All developing and transition countries[c]	36.7	50.3

a. 1997–99 values (IMF May 2002 paper on "Alternative Quota Formulas—Further Considerations). **b.** Includes the voting share of the constituency of Nordic countries, although the current executive director comes from Norway. The constituency led by Switzerland controls 2.85% of the voting power. **c.** Definition in *International Financial Statistics*, which includes the Republic of Korea as a developing country.

the degree of access to be given to a country in relation to its quota, rather than as a determinant of the quota itself. In that case quotas might as well be determined purely by relative GDPs, and the link with voting shares could be retained.

Implementing principles along these lines would increase the voting share of developing and transition countries from about 37% to about 50%, with the corresponding decrease in the voting share of industrial countries focused on European countries (see table 4.1). Assuming the link with quotas were retained, such a redistribution of voting shares could be achieved only in the context of an overall increase in total quotas—although that in turn could be achieved, as is now proposed, at least in part through a selective ad hoc increase in quotas for a relatively small number of countries. As argued above, this might be appropriate. And it would put in place a system that would lead to a further automatic increase in the voting shares of developing countries as and if their economies continue to grow faster than those of developed countries.

Table 4.2 **Current structure of the IMF board**

Country of executive director	Other members of constituency	Voting share (% of total votes)
United States		17.14
Japan		6.15
Germany		6.01
France		4.96
United Kingdom		4.96
Belgium	Austria, Hungary, Belarus and others	5.15
Netherlands	Ukraine, Romania, Israel, Bulgaria and others	4.86
Mexico	Spain, Venezuela and others	4.29
Italy	Greece, Portugal and others	4.19
Canada	Ireland, Caribbean countries	3.72
Norway	Sweden, Denmark, Finland and others	3.52
Korea, Republic of	Australia, New Zealand, the Philippines and others	3.34
Egypt	Kuwait, Iraq, Libya and others	3.26
Saudi Arabia		3.23
Malaysia	Indonesia, Thailand and others	3.18
Tanzania	South Africa, Nigeria and a group of mainly Anglophone African countries	3.01
China		2.95
Switzerland	Poland, Uzbekistan and others	2.85
Russian Federation		2.75
Iran	Algeria, Pakistan, Morocco and others	2.47
Brazil	Colombia, Ecuador and others	2.47
India	Bangladesh, Sri Lanka and Bhutan	2.40
Argentina	Chile, Peru and others	2.00
Equatorial Guinea	Group of mainly Francophone African countries	1.42

Board size and constituency system. The constituency system in the IMF is a source of strength. But at 24 members the board is now too large to be effective, and with 8 board seats (sometimes 9, when Spain holds the chair of its constituency) European countries are grossly over-represented (see table 4.2). A reduction in European voting shares would provide a golden opportunity to downsize the number of board seats. An effective board might have 15 members representing 15 constituencies. Membership of such constituencies should be left to member countries to decide, within some preset rules such as the minimum voting share needed to form a constituency. The current rule permitting the five countries with the largest quotas to appoint their own executive directors should be dropped. There should be a major reduction in the number of constituencies led by European countries, perhaps to three or four at most. Other seats might end up divided—say, four led by countries in the Americas, two by countries in Africa and five or six by countries in the Middle East, Asia, Australasia and the former Soviet Union. Such a reorganization would almost inevitably reduce the number of mixed constituencies (of developed and developing countries), which have proved valuable in reducing polarization and spreading understanding of other countries' problems, but this would be a price worth paying. The size of the IMFC would be reduced correspondingly.

Role of the board and relationship with management. As board members have become more and more subject to instructions from their home countries, the engagement of the board in detailed decision-making has become less and less helpful. There is evidence that board involvement has reduced the quality of bilateral surveillance—and in some cases led to poorer lending decisions. The board's size has led to a reluctance to use it as a forum for discussing the most sensitive issues and to the increased use of informal, less transparent groups such as the G-7 for considering such issues. In any event, there is a strong case for applying in the IMF the principles of governance developed in recent years in the corporate sector and in defining relations between governments and operating agencies such as independent central banks. Management should be given more freedom to manage, and the board should exercise an oversight function within a much stronger system of accountability for management's performance. Many suggestions have been made. A workable arrangement might involve the following elements:

- A non-resident strategic board—as suggested by Kenen and others (2004)—meeting perhaps once a month, with members drawn from deputy ministers, and a specific remit to exercise general oversight rather than engage in individual decisions. It would not discuss surveillance reports—other perhaps than the *WEO* and GFSR, where such a group could add real value. And it would leave most lending and programme decisions to management—perhaps other than where exceptional access is proposed or where a group of directors asked for a discussion. It would regularly review performance against a set of indicators, and decide policy on strategic issues such as proposals for new lending facilities. Principles of good corporate governance suggest it should probably be chaired by someone other than the managing director. Some constituencies could choose to post their director in Washington, D.C.; that would be a matter of choice. And directors representing large numbers of borrowing countries would have much more time to devote to handling their relations with the IMF. With board members at this level, in many cases performing key government functions, there would be no need for separate meetings of the IMFC deputies. Neither the board nor its members would be "executive" and their titles might be altered correspondingly.

- The parallel creation of a new management board, comprising the managing director and perhaps five deputy managing directors selected or appointed to reflect the geographical diversity of the IMF's membership, charged with making decisions as a college on surveillance reports and country programmes. (There are parallels—for example, in the responsibilities of vice presidents at the European Investment Bank, or members of the European Central Bank. There might need to be internal arrangements to ring-fence surveillance activities to keep them separate from the IMF's programme activities. Appointments to this management board might be for fixed terms; and responsibilities and loyalties—to the institution—would need to be carefully defined. Accountability to the board could be supplemented, as in some central banks, with a degree of transparency in decision-making. These arrangements would help protect the institution from too much influence by any one member country and also ensure greater consistency and coherence in the institution's decisions.

This is a radical set of proposals. They are not presented as a blueprint, more as an indication of the nature of changes required to better match the Fund's governance structures to the realities and emerging governance practices of the twenty-first century.

Operating budget and costs of proposals

The IMF's operating budget has increased greatly in recent years. Yet the Fund is now facing the prospect of a sustained loss of income as a result of lower lending activity. Proper budget oversight and priority setting is thus even more important. Management is seeking to improve the budgeting systems and bring them up to date. General oversight of the budget would be an important function for a more strategic board, along the lines suggested above.

A separate but important issue is how the operating budget is paid for. Who, for example, pays for stepped-up monitoring of financial sector issues and increased follow-up technical assistance? At present it is paid for out of margins on IMF lending. The proposals made in this chapter, taken as a whole, should not increase costs. For example, savings from moving to a non-resident board would offset any increased costs from enhanced monitoring and surveillance activities. But if the current fall in income were to be sustained or if, for whatever reason, the budget were to increase further it might be appropriate to examine other possible sources of income, such as making better use of resources currently held as gold.

Evaluation

Established in 2001, the IEO is already performing a useful function. But in parallel to its work, more needs to be done to develop procedures for regular internal evaluation. For example, the October 2004 meeting of the IMFC called on the IMF to "develop a methodology for better assessing the effectiveness of surveillance". A similar approach should be applied elsewhere and will be essential—alongside a continuing series of high-quality assessments from the IEO—if in the future the board is to focus more on its general oversight and policy-setting functions and exercise them effectively.

Other changes needed to help promote global financial stability

The preceding section identifies several changes that would improve the IMF as the principal institution responsible for promoting global financial stability. But as noted in earlier sections, the IMF's role depends on a range of other institutions and organizations performing effectively. Are there weaknesses or gaps in this wider system that should be addressed alongside steps to strengthen the IMF? Broader issues worth further consideration include:

- *Adapting to the changing balance of economic power in the world*. This and the related issue of the perceived legitimacy of different forums go beyond the IMF. For example, the exchange rates and financial systems that matter most to the world are increasingly those in China and other emerging economic superpowers. Should the G-7, which has traditionally discussed relations between the world's major currencies, be expanded or adapted to include China, which is responsible for the world's fourth most important currency? The recent proposal to create a G-4—United States, Eurozone, Japan and China—to discuss the most sensitive global currency issues has much to commend it. For broader financial stability issues currently discussed in the G-7 and G-8, the best approach might be to make more use of the G-20 grouping of finance ministers and central bank governors. The G-20 now has an extensive agenda, including multilateral review of economic policies as well as most of the issues discussed in this chapter. Among the other institutions and groups active on financial system and stability issues, some (Financial Action Task Force (FATF), BIS and the global tax forum) have taken steps to bolster their legitimacy by expanding their membership. Others have not. To retain legitimacy, organizations such as the FSF and the global accounting and auditing bodies need to consider expanding their memberships.
- *Handling the interactions between financial supervisory regimes and macroeconomic developments.* For example, should bank capital requirements be relaxed at times of global economic stress? This is the type of issue where the IMF as the principal institution for financial stability might have been expected to play a larger role than it has hitherto.
- *Handling a crisis caused by failure of a major global private sector conglomerate.* A difficult case would be a global conglomerate based in a country where the government might not have the resources (or will) to come to the rescue. It is not clear if there are adequate procedures in place to handle such an event. To fulfil its role of global institution for financial stability, the IMF

should at a minimum be working with other bodies such as the BIS and FSF to ensure that such potential sources of instability are identified in advance, along with procedures to handle them.

Conclusions and recommendations

Taking a broad definition of financial stability, the IMF has a good claim to be considered the principal institution, but to be effective it must operate within a network of other institutions and groups. Compared with other international institutions, the IMF has many strengths: professionalism, flexibility, speed of response, governance and legitimacy. This assessment has identified some gaps in current arrangements and issues that will require attention if the Fund is to adapt to changing expectations. It identified a number of proposals—in some cases very tentative—for improvement. The very brief discussion of other apparent gaps in global governance in this area, going beyond the IMF, suggested some further issues that need attention. Key suggestions and recommendations include the following.

Legitimacy and membership. Near universal membership and the perceived legitimacy of its governance structure are strengths, making it particularly important to address current concerns about voice and representation of some members in the governance structure. These concerns are already undermining the IMF's perceived legitimacy.

Mandate, powers and obligations of members. The formal mandate and obligations of members cover most of what is required to promote global financial stability, but there are gaps—including jurisdiction in relation to capital flows and surveillance powers (and corresponding obligations)—in areas other than macroeconomic policy, such as financial sector regulation. The IMF has shown it can do much in these areas voluntarily. This approach can continue. But there is a case for aligning the formal mandate and obligations better with the task the Fund is asked to do. A review would provide an opportunity to revisit the capital account responsibilities of the IMF and the SDRM and address aspects of the division of responsibilities with the World Bank and WTO.

Agenda setting and intergovernmental processes management. Agenda setting has been and should remain principally a task for member governments. But there is scope for the IMF to be more proactive in managing intergovernmental processes—seeking to provide a stronger input into the G-7, G-8 and G-20. (Alternatively, this would happen more automatically if progress were made on the ideas for a smaller IMFC and a smaller, more senior and strategic non-resident board.)

Surveillance and monitoring. Substantial changes have been made in recent years in stepping up assessment of members' policies on the financial sector and related issues and in increasing transparency. The quality of the Fund's analysis and policy advice in these areas and in macroeconomic policy is generally accepted to be high. But some issues need attention:

- Assessments of some key risks to financial stability could be better integrated into the mainstream bilateral surveillance activity (article 4 consultations). In developed countries greater attention should be given to financial sector and systemic risks from nationally supervised financial institutions and markets; in developing countries, such issues as currency mismatches and debt sustainability.
- It is important to look for ways to better communicate the results of surveillance to increase its effect on policy decisions. Advice should be candid, certainly in private, but it also needs to be effective in influencing policy. Maybe the best approach is to start with confidential messages; if these are not heeded, then proceed to making the IMF's concerns more transparent.
- It is also important to search for ways to increase the impact of the IMF's advice in developed countries. The best approach may be to strengthen the multilateral surveillance process, using the G-7 or similar groups to apply peer pressure. This will require stronger efforts by the Fund to interact with such groups and deliver its messages effectively.

Technical assistance and capacity building. Where weaknesses are revealed in country systems, follow-up assistance and capacity building is often needed. But rather than seeking to build the IMF's resources in this area, it would be better to cooperate more strongly with the World Bank, bilateral donors and others who have a comparative advantage in managing and providing this kind of assistance. The IMF would then have a key role in identifying the need for assistance (including advising on cases where significant medium-term lending by multilateral development banks is needed when countries are acting to reduce their vulnerability to capital account crises), in monitoring follow-up and perhaps in filling gaps left by other assistance providers of technical assistance with capacity building.

Crisis management and financing. The conclusions of recent IEO evaluations of the Fund's role in several crises in the 1990s suggest some important lessons for the future, including the need for simplicity and focus in crisis programmes; early involvement of creditor governments when there appears to be a collective action problem for their institutions and investors; an adequate total financing package provided in a common framework; and a contingency strategy in case of failure of the initial approach. In addition:

- There may be a good case for higher access limits than those recently imposed—combined, if necessary, with an increase in IMF quotas—together with stronger acceptance of the need for exceptional access in countries heavily exposed to capital flows. But to avoid giving the wrong signals to private markets and investors, this effort should go hand in hand with a clear understanding that on some occasions countries will not meet all their debts (requiring debt restructuring and standstill arrangements), and on others parallel action will be required to address collective action problems among private investors. After a period of experience with the current voluntary approach—and the wider use of collective action commitments in bond contracts—it may be sensible to revisit proposals for more formal mechanisms and procedures for handling orderly debt restructuring, such as the SDRM.
- If increases in resources available through the Fund are needed, they should be achieved through an increase in quotas, not a distribution of SDRs.
- Regional monetary funds could fill a useful role in supplementing IMF finance so long as their finance supports the policy framework agreed with the IMF.
- A functioning contingent credit facility could play a useful role. One way forward would be for the new facility now proposed to replace the CCL to provide automatic access for countries declared eligible by the IMF. (There would be no need to apply, and most but perhaps not all developed countries could be declared eligible.) While this would also give the IMF a signalling function, if exercised competently and professionally, it could add value to the value of the idea.

Expertise and culture. A willingness and ability to cooperate well with other institutions—relying on their judgements and expertise when necessary—are crucial to the Fund's effectiveness. Its history of working largely alone in a single area means it will take a deliberate and sustained effort by management to bring about the required change in institutional culture.

Management and internal processes. Competent and professional management and good processes for achieving cohesion have been a source of strength. But in common with other institutions, changes are needed to bring management and processes in line with best modern practice. There is a particular need to develop measures of effectiveness and benchmarks to support stronger accountability and governance.

Governance. Many elements of the IMF's system of governance have been a source of strength: voting arrangements, the constituency system, the executive board. But there are now widely shared concerns about governance that, are already beginning to call into question the institution's legitimacy and undermine its effectiveness.

- *The process for appointing both the managing director and first deputy managing director needs reform.* Radical change—for example, appointing an international group of "wise men" to select and appoint the best person for the job—could take place only in the context of a broader reform for appointments to the heads of the World Bank and WTO, and possibly other global institutions as well. But more modest changes could be made within the current conventions to give greater confidence of selecting candidates of the highest quality while also increasing the role of the broader membership in the process.
- *Voting shares need to be adjusted to reflect better current economic realities.* A possible reform could contain three elements:
    1. Voting shares based primarily on GDP measured on a PPP basis, with a small contribution also from a given number of basic votes per member and with a system for regularly and automatically updating assigned shares as economies change in relative size.
    2. Protection for creditor countries, if required, through special voting requirements.
    3. Weight given to countries' vulnerability to current and capital account flows in determining the access granted in relation to quota size—not in the quotas themselves.
- *The board needs to be made more effective, smaller and more strategic.* One approach that would help address many concerns, would be along the following lines:
    1. Take the opportunity of reductions in the European voting share that would result from the proposals above

to greatly reduce the size of the board, perhaps to 15 in total. (There would automatically be a corresponding reduction in the size of the IMFC.)

2. Convert the board into a non-resident and clearly non-executive board of representatives at the deputy minister level, meeting at most once a month. It would leave surveillance and nearly all lending decisions to management, address policy and strategic issues and hold management to account for performance. It would be complemented by an internal management board of the managing director and deputy managing directors, which would act as a college to make most of the individual surveillance and lending decisions currently taken by the board.

Operating budget and cost of proposals. Setting and monitoring the operating budget would be an important function for a more strategic non-executive board. Implemented as a package, the proposals in this chapter should not increase costs, with savings from the more streamlined governance arrangements offsetting any extra costs of enhanced surveillance and monitoring activities. But if there is a sustained fall in the IMF's income, or if, for whatever reason, the budget needs to be increased further, consideration should be given to providing extra resources by making better use of the Fund's assets currently invested in gold.

Evaluation. The new IEO is already performing a useful role. Its activities need to be matched by a stronger process for internal evaluation and performance monitoring. This is essential if the functioning and role of the board changes, as suggested above.

Issues extending beyond the role of the IMF. There are a few issues that may be critical for global financial stability but go beyond the role of the Fund. There may well be others.

- There are questions about the membership and legitimacy of some of the supporting groups and institutions. The G-7, which has traditionally discussed relations between the world's major currencies, excludes the country responsible for the world's fourth most important currency (China). Other issues currently discussed in the G-7 and G-8 would be better discussed in a group (such as the G-20) that includes the world's other major economic powers. While the FATF and BIS have expanded membership to include important emerging market countries, other groups (the FSF and accounting standards bodies) have not.

- Some global institution—maybe the IMF—should be considering systemic interactions between macroeconomic developments and financial sector supervisory regimes.
- Future global financial crises may be unlike those of the 1990s—perhaps in areas (such as the collapse of a major global financial conglomerate institution) where the IMF has little relevant experience or power to act as manager. Thought should be given to how such crises would be handled. It seems an appropriate role for the global institution for financial stability to work with others such as the BIS and FSF to ensure that this takes place.

Implementing this agenda for change would take time. All but the recommendations on legitimacy and membership and on the mandate and obligations of members could, if agreed, begin to be implemented fairly quickly using existing mechanisms. The April 2006 Medium-Term Strategy indicates some moves already under way towards partly implementing some of these recommendations.

But enacting the proposals for reviewing the IMF's formal mandate and radically changing its governance arrangements would inevitably take a period of reflection and discussion among member countries. They constitute a coherent package aimed at strengthening the Fund's legitimacy and effectiveness as an institution responsible for providing an important global public good. Another reason for considering them as a package is that it might prove easier to get agreement on a package than on its components. As to procedure, it would be sensible to seek to reach agreement first among a group of senior representatives of the world's major economic powers. The G-20 might prove a natural group for the purpose: it has a well established process at the deputy minister level, and is already considering many of the issues discussed here.

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Anti–money Laundering as a Global Public Good

5 Chapter

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Money laundering is the conversion of the proceeds of criminal incomes into assets that cannot be traced back to the underlying crime. The global anti–money-laundering (AML) regime originated with the criminalization of this activity by the United States in the mid-1980s and the establishment of the multilateral Financial Action Task Force (FATF) on money laundering in 1989. Today, the International Monetary Fund (IMF) and the World Bank are centrally involved in monitoring compliance.

The AML regime contributes to the provision of global public goods by reducing crime; protecting the integrity of the financial system; and limiting terrorism, corruption and state failure. The regime has two pillars. First is a prevention pillar that involves due diligence about customers, as well as reporting obligations, supervision and regulation, and sanctions for non-compliance. Second is an enforcement pillar that starts with identification of predicate or underlying offences. Other elements are investigation, prosecution and punishment, and confiscation of funds that were laundered. The prevention pillar is well developed. The enforcement pillar has been building slowly in the United States, and even more slowly elsewhere.

The AML regime has improved the efficiency of law enforcement only on the margin. It has had limited success in controlling global terrorism, corruption, kleptocracy and state failure. Nonetheless, it has succeeded in limiting the threat of money laundering to the integrity of the core financial institutions in the major financial centres. It is more difficult to determine whether this success extends to non-core financial institutions or institutions headquartered outside the major financial centres.

This contribution makes six recommendations to improve the structure and functioning of the global AML regime: development of quid pro quos to achieve greater international cooperation, emphasis on corruption, articulation of global

AML strategies, financial as well as technical assistance, preparation of a periodic global report on money laundering and pursuit of a cooperative research strategy. This report provides a qualitative benefit-cost evaluation of 15 items under these six categories.

Money laundering is the conversion of the proceeds of criminal incomes into assets that cannot be traced back to the underlying crime. The activity conventionally is divided into three phases: placement of funds derived from an illegal activity, layering of those funds by passing them through many institutions and jurisdictions to disguise their origin and integration of the funds into an economy where they appear to be legitimate. AML is the criminalization of this activity.

Although money laundering has been around as long as criminal activities have produced revenues, anti–money laundering dates back only to the mid-1980s when the activity was criminalized in the United States as part of a campaign against drug trafficking. Over the past two decades, anti–money laundering has become a global regime. The tools of the global AML regime are used to reduce the incidence of crime, to protect the integrity of the financial system and to deliver global public goods, for example by reducing global "public bads," such as terrorism and corruption.

Anti–money laundering is a quintessentially *international* cooperative effort. National borders are more porous to physical or electronic flows of funds than they are to flows of information. The reason is that sovereign powers of nations run into roadblocks at borders. Therefore, money laundering frequently involves a cross-border dimension, even when the underlying crime does not. Borders facilitate the laundering of the proceeds of crime, and globalization facilitates the transfer of money across borders. Money laundering and other abuses of the global financial system have been described as the dark side of international capital mobility—a salient feature of globalization.

Thus, money laundering and the global AML regime are issues of global concern. However, it may be less clear whether the AML regime is a global public good. The first section of this contribution provides the rationale for viewing the AML regime as a global public good, rather than another technique of fighting crime. The following section provides a description of the global AML regime. An assessment of the global AML regime is provided in the third section. The fourth section puts forward six recommendations for advancing the AML regime as a global public good. The final section provides a qualitative benefit-cost evaluation of the 15 specific items covered by these six recommendations.

Is the global AML regime a public good?

The global AML regime is a means to an end, not an end in itself. It is a tool that is used to achieve other ultimate objectives. Therefore, one might argue that anti–money laundering cannot be a public good, or a global public good, because it is an intermediate, not a final, product.

Still, the objectives of the global AML regime are public goods, and most have an international dimension. The objectives include reducing blue-collar and white-collar crime, protecting the stability and integrity of the financial system and combating such global "public bads" as terrorism, corruption and state failure.

Thus, the goals of the global AML regime clearly satisfy three tests for an international public good. First, the goals are important to the international community. Second, they cannot be adequately achieved by individual countries acting alone. Third, developing as well as developed countries must address them collectively on a multinational basis. Thus, the global AML regime is a collective tool used by the international community to achieve multiple global public goods. The AML regime itself can be thought of as a global public *intermediate* good or as part of the infrastructure for the provision of global public *final* goods.

This characterization of the global AML regime as a piece of infrastructure contributing to the achievement of multiple objectives has three important conceptual implications. First, the benefits of achieving the various objectives of the AML regime may not be valued equally, absolutely or relative to other objectives, by all countries participating in the global system; in particular they may be more highly valued by developed than by developing countries. For the global AML regime to be effective, however, in contributing to the outputs valued by some countries, a reasonable degree of participation in the global AML is required by all countries because the regime is only as strong as its weakest link.

Second, participation in the global AML regime may be regarded as a luxury, and therefore as an activity that poorer countries cannot afford. We have very little information on the cost of participation in the global AML regime, where a correct accounting of the costs would include those borne by governments (taxpayers), the private sector and the general public. Reuter and Truman (2004, chapter 4) put together a crude estimate for the United States of $7 billion, or about $25 per capita. Even if the true figure were less than half as large for a poor developing country, say $10 per capita, it would be a considerable amount to pay to participate fully in the global AML regime compared, for example, with average annual health expenditures of $22.60 per capita estimated on average for low-income countries in 2001 (World Bank 2004).

Third, there are no credible estimates of the volume of money laundering, the countries that participate in laundering money, or the activities that generate the largest amounts of it (Reuter and Truman 2004, chapter 2). The aggregate annual figure is probably in the hundreds of billions of dollars, but whether it is a small number of hundreds or more than a trillion is unknown. The vagueness of existing estimates of amounts of money laundered annually arises both from disagreements about concepts and from weaknesses in the techniques used to quantify the activity. As a consequence, it is inappropriate to use changes in the volume of money laundered as a performance measure for judging effectiveness of the global anti–money-laundering regime.

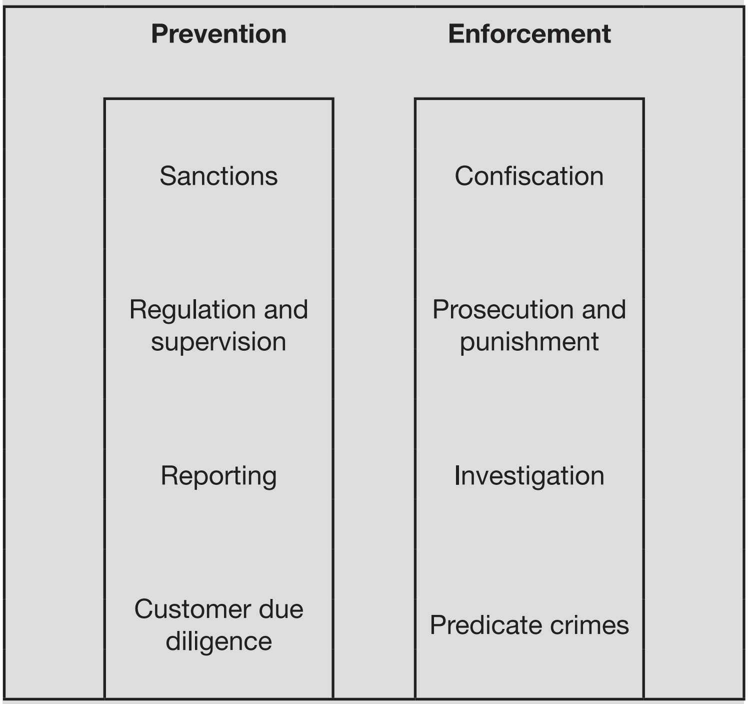
Moreover, any aggregate figure for the global total of money laundered each year would conceal as much as it revealed. The adverse social consequences of a million dollars laundered to finance terrorism, at one extreme, and those from a million-dollar embezzlement, at the other extreme, are so different that adding the two figures together would not produce a valuable figure for policy purposes. What is needed, but not available, are reliable figures for the major components of the total associated with each of the major goals, or subsidiary goals, of the global AML regime.

What is the global AML regime?

The global AML regime is constructed on two basic pillars: prevention and enforcement (see figure 5.1).[1] The prevention pillar is designed to deter criminals from using private individuals and institutions to launder the proceeds of their crimes. The enforcement pillar is designed to punish criminals when, despite prevention efforts, they have successfully used private individuals and institutions to launder those proceeds.

The prevention pillar has four key elements from bottom to top: customer due diligence, reporting, regulation and supervision, and sanctions. Customer due diligence is intended to limit criminal access to the financial system and other mechanisms for placing the proceeds of

Figure 5.1 **The AML regime**



crime. Reporting requirements alert the authorities to activities that may involve attempts to launder those proceeds. Regulations implement anti–money-laundering laws and often specify detailed due diligence and reporting requirements, while supervision helps to encourage compliance with laws and regulations by covered financial institutions and non-financial businesses. Finally, sanctions punish individuals and institutions that fail to implement or to comply with the requirements of the prevention pillar, in particular with respect to due diligence and reporting requirements.

The enforcement pillar also has four key elements from bottom to top: a list of underlying offences or predicate crimes, investigation, prosecution and punishment, and confiscation. The list of predicate crimes establishes the legal basis for criminalizing particular money-laundering actions; certain crimes, such as tax evasion, may not be the basis for prosecution for money laundering. Various detection and investigation techniques are used to identify money laundering and link it to predicate crimes. If the investigation justifies prosecution and ultimately conviction, the money launderer may be fined and sentenced to prison, and the proceeds of the crime may be confiscated or forfeited after having been initially blocked or seized. Forfeiture is not only a further disincentive to criminal activity, but also in some countries a means to help finance law enforcement activities.

The US anti–money-laundering regime is central to the global AML regime because proceeds of crimes are moved from and to the United States and the US financial system as the result of criminal activities that may have taken place in the United States or elsewhere. Even when the criminal activity may have been outside the United States, the US financial system and economy are frequently the ultimate destination, or at least the conduit, for the proceeds of crimes because of the central role of the US economy, currency and financial system in the world today. Moreover, the US AML regime is often, but not always, a model for other national regimes.

The most stringent US AML requirements apply to core financial institutions, particularly banks. They are required to have comprehensive AML compliance programmes. With respect to customer due diligence, these institutions must comply with extensive requirements in setting up new accounts and in conducting transactions. The assessment requirements are risk based in the sense that the amount of information that is required depends on (a) the institution's size, location and customer base; (b) the customer's size, location and type of business; and (c) the services offered to the customer. If the institution is unable to satisfy itself in the course of its due diligence, it is generally expected to decline to open the account or complete the transaction. It is also required to retain records of its customer due diligence activities.

US banks must submit suspicious activity reports, as well as reports on certain cash transactions and international transportation of currency or monetary instruments. One criticism of the US AML regime is that these reporting requirements generate a lot of data that contribute to information overload, making it difficult for the recipient agencies to use the information efficiently in law enforcement and related investigatory activities. One criticism of AML regimes in most other countries is that there are no such cash-reporting requirements.

Banks in the United States also are subject to substantial supervision, normally including on-site examinations once a year. This supervision is intended to ensure that the institutions are complying with a wide array of laws and regulations, including those associated with the AML regime, as well as those intended to ensure that the institution is being operated in a safe and sound manner.

If an institution is found to have fallen short of what is required or to have been sloppy in its implementation of AML regulations, rules and supervisory guidance, it can be subjected to informal or formal administrative actions by the regulator and may incur civil and criminal penalties. These examinations rarely turn up direct evidence of actual money laundering; they primarily serve to reinforce the prevention pillar of the overall AML regime.

The four elements of the prevention pillar of the US AML regime apply comprehensively and robustly to US banking institutions. They apply less robustly to other types of core financial institutions, securities firms and insurance companies, in part because the comprehensive coverage of those institutions has been authorized and implemented more recently, for example, in connection with the USA Patriot Act that was passed in the wake of the 11 September 2001 attack. The coverage by the prevention pillar of the US AML regime of non-bank financial institutions (for example, money transmission businesses), non-financial businesses (for example, casinos) and professions (for example, lawyers and accountants) is even less comprehensive, in part because the federal-level supervisory regime that applies to them is either non-existent or underdeveloped and in part because the case for their coverage has not yet been made.[2]

The list of predicate crimes or underlying offences that could lead to a US conviction for money laundering was relatively short in 1986 when the Money Laundering Control Act criminalized money laundering. The primary focus then was drugs and drug-related criminal activity. The list has been expanded considerably in subsequent AML legislation and currently covers almost every kind of serious crime, from environmental violations to health-insurance fraud. Conspicuously, however, the US list of predicate crimes does not include tax evasion in the United States and only includes a limited number of crimes committed abroad.[3]

Confiscation of the proceeds of crime through seizure and forfeiture procedures is a powerful element of the enforcement pillar of the US AML regime.[4] Successful confiscation serves as a deterrent to criminal activity and deprives criminal organizations of some resources. Another important aspect is the sharing of the proceeds with other jurisdictions. At the federal level, the United States has a programme for the equitable sharing of forfeited property with other federal, state and local jurisdictions. In addition, since 1988 the United States has had a programme of equitable sharing of forfeited assets with foreign governments that cooperated and assisted in investigations. From 1989 to March 2002, the international asset-sharing programme shared 44% ($171.5 million) of eligible forfeited assets with 26 foreign governments.

In 1989, the Paris Economic Summit established the FATF on Money Laundering as a temporary body, housed at the OECD but separate from that organization. The principal motivation for the establishment of the FATF was to combat the drug trade and the financial power of drug trafficking and other organized crime groups whose activities are facilitated by money laundering. The task force is interdisciplinary in that delegations included supervisors, officials from finance ministries and representatives of ministries charged with law enforcement. This feature has contributed to an impressive amount of intragovernmental cooperation as a positive byproduct of intergovernmental cooperation. The FATF's initial five-year mandate was to assess the results of cooperative efforts to date and suggest additional preventive steps that could be taken.[5]

In 1990 the FATF promulgated its Forty Recommendations on Money Laundering providing the first steps towards a global AML framework. The recommendations start with ratification and implementation of the 1988 Vienna Convention, outline the role of national legal systems and the financial system and its regulators in combating money laundering, and lay down principles of international cooperation.[6] The Forty Recommendations were slightly revised in 1996. In October 2001 the FATF also issued Eight Special Recommendations on Terrorist Financing, and a ninth recommendation was added in late 2004. Finally, in 2003, a comprehensive revision of the Forty Recommendations was completed. It extends the global AML regime, at least on paper—by including due diligence, reporting, regulation and supervision, international cooperation and various aspects of law enforcement—to cover the financial sector, the non-financial sector and gatekeepers, such as lawyers and accountants.

The FATF is without significant enforcement power over jurisdictions that do not live up to its standards. It sponsors self-evaluations and peer reviews of its members, thus exercising global-level supervision, but with more limited scope than national supervisors to sanction non-compliance. It has also issued statements critical of the actions or inaction by non-FATF jurisdictions, starting with the Seychelles in 1996.

The FATF's success in forcing the Seychelles government to impose AML rules on its financial businesses inspired a more comprehensive effort to identify Non-Cooperative Countries and Territories (NCCTs) elsewhere in the world. The objective was to identify regimes that did not meet internationally recognized standards for the prevention, detection and punishment of money laundering. This "name and shame" initiative was launched in 2000. An initial list of NCCTs was published by mid-2000.[7] While most of the jurisdictions on the list were very small, the list has included some larger nations, such as Egypt, Indonesia, Nigeria, the Philippines and the Russia Federation. Although 23 jurisdictions failed their initial FATF reviews, as of June 2006, only 1 country remained on the list.[8]

After two years of debate, the FATF, the IMF and the World Bank agreed in the fall of 2002 on a one-year pilot project for assessing compliance with international standards for anti–money laundering and combating the financing of terrorism (CFT), in effect transferring most of the peer reviews and evaluations of FATF members and non-members to these organizations as a step towards a system of global supervision.[9] Participation in an IMF/World Bank AML/CFT review is entirely voluntary.

The IMF and World Bank have no powers to sanction except, perhaps, via the publication of their reports, which currently requires the approval of the country in question. As of end-February 2004, IMF/World Bank reports on 19 reviews had been completed as part of the pilot project. As of early September 2005, 16 of those reviews had been published in whole or in part, and an additional 7 reviews had been completed and published.[10] The IMF and World Bank have limited scope to promote compliance with global AML/CFT standards through their lending and technical assistance programmes.

Notwithstanding the drawbacks to IMF/World Bank monitoring of compliance with international AML/CFT standards, the G-7 and the FATF in early 2004 called for making the pilot programme permanent and more comprehensive. The call for more comprehensive assessments was motivated by a desire that the IMF and World Bank integrate the treatment of criminal law enforcement and prudentially unregulated financial activities into one integrated assessment document. In March 2004 the executive boards of the IMF and World Bank agreed to do so.

How effective is the global AML regime?

Assessment of the accomplishments of the global AML regime is complicated by the fact that the regime is best regarded as an infrastructure providing the means to assist in the achievement of multiple objectives that may be valued differently by different countries and observers. Moreover, the global regime is still under development. Nevertheless, it is useful to consider the accomplishments to date of the global AML regime in three areas: reducing crime generally, protecting the integrity of financial systems and controlling global "public bads", such as terrorism, corruption, kleptocracy and failed or failing states.

Reducing crime

We lack objective indicators of the role of the AML regime in reducing various predicate crimes, ranging from drug-related crimes to fraud. So we have to rely on indirect measures, such as numbers of suspicious activity reports, prosecutions and convictions, and seizures and forfeitures.

We have the most information about the United States, where the flow of money-laundering convictions is modest, no more than about 2,000 a year. Given the suspected scope of the activity, this low conviction rate suggests that money laundering is not a very risky activity, particularly since most of the convicted launderers are associated with sums of less than \$1 million. However some who provide money-laundering services may be convicted on other charges. Thus there is no way of measuring the actual risk a money launderer faces of going to prison. Moreover, the number of stand-alone money launderers offering their services to criminals appears to be relatively small, compared with money-laundering activities that are integrated with the criminal act itself or linked to one criminal act or one criminal. Seizures and confiscations of about \$700 million a year in the United States suggest that either a trivial fraction of laundered money is seized or that much less is laundered than is indicated by official statements about the scale of the activity.

The existing US regulatory system and the information it generates are not well used in prosecutions. Suspicious activity reports rarely initiate investigations; rather they are used as additional information for making a case based on another lead. Indeed, apart from sting operations, money laundering is rarely the initial offence for an investigation in the

United States. The relative de-emphasis of drug investigations in recent years has apparently led to less commitment to money-laundering expertise in some key US law enforcement organizations. The much greater emphasis now on countering terrorism has enhanced the role of financial investigations in that area, but at the expense of money-laundering investigations generally.

We have less systematic information about other countries. It appears that no other nation prosecutes money-laundering offences as aggressively as does the United States, which is a common complaint of US officials involved in international money-laundering matters. Even with the creation of systems that generate large numbers of reports of suspicious activities, there is little evidence of the substantial use of criminal investigations to make cases against violators or to achieve a significant number of convictions. The Netherlands, which has a relatively sophisticated capability in criminal intelligence and the investigation of organized crime, may be an exception to that statement, but the numbers for major cases clearly are small, about 20 cases per year involving more than $500,000.

Taking this suggestive evidence at face value, what explains the differences between the United States and other wealthy nations with sophisticated financial and judicial systems? First, drug trafficking, central to the creation of the AML regime, has been a more important problem in the United States than in any other industrial nation. Second, the United States launched a moderately successful prosecution campaign against the Mafia in the 1970s and 1980s; that campaign developed many of the legal tools and much of the organizational expertise for money-laundering prosecutions. In only a few other nations (notably Italy) has organized crime been prominently prosecuted. The United States also has a more aggressive law enforcement culture generally. These observations serve to underline the difficulty of making comparisons about AML enforcement regimes among wealthy countries, much less among a broader set of countries.

Protecting the integrity of financial systems

Although the principal objective of the global AML regime is to make it more difficult (expensive) for criminal offenders to launder the proceeds of their crimes, an important subsidiary objective has been to protect the integrity of the financial system itself. Thus, for example, the Basel Committee on Banking Supervision stated in its report on customer due diligence for banks (2001, p. 2) that such controls are not only important to support the law-enforcement related work of the FATF, but they also serve "a wider perspective. Sound KYC [know your customer] policies and procedures are critical to protecting the safety and soundness of banks and the integrity of banking systems."

Core financial institutions today are generally regarded as quasi-public utilities, enjoying access to a governmental safety net of deposit insurance, as well as to a discount window and to payment services. As a consequence, those institutions, particularly banks, are expected to share broad social objectives and abide by generally accepted social and ethical codes of behaviour. They are expected to assist in supplying other public goods, such as the prevention of money laundering and the protection of the integrity of the financial system as a whole. According to this view, financial institutions that accept money from drug dealers, even if they do not face criminal charges, are perceived to be less law-abiding than others. Moreover, once the social objective of combating money laundering has become well established, a bank suffers a loss of reputation when it becomes associated in the public mind with money laundering, though the seriousness of that reputation loss may vary from society to society.

In addition, if banks and other financial institutions at the centre of the financial system are to play their assigned role in the economy, their customers must trust them. Such confidence, in turn, helps to prevent runs on banks, which can undermine the stability not only of the financial system but also of the economy as a whole. Thus a financial institution that fails to establish appropriate AML-compliance procedures incurs legal and financial liability that can impact its bottom line as well as its reputation. The money-laundering regulations can be viewed as a way of insulating banks and other similar institutions from direct connections with illegal activities.

Consider the interaction of organized crime, corruption, money laundering and a weakened financial system in the Russian Federation in the 1990s. Criminal groups intent on hiding the proceeds of their crimes gained control of banks; this allowed them to corrupt the business and financial system more broadly; the government and other institutions of society also became tainted; and ultimately the phenomenon spread to other countries (Cyprus, Nauru), mixing with money laundered from crimes in other countries. Although in the late 1990s the Russian Federation did not have much of a banking system to corrupt, this process of undermining the integrity of the financial system can proceed anywhere.

At the extreme, as argued in a UK report (Performance and Innovation Unit 2000, chapters 3, 7), "the accumulation of criminal assets in a country's financial system can influence decisions about national banking policies or about co-operation in international investigations, transparency and accountability rules." The Bank of Credit and Commerce International (BCCI) experience illustrates this extreme. BCCI caused substantial disruption to the international financial system when its nefarious activities were finally uncovered in 1991. It was found guilty of numerous violations of the banking laws in a number of countries, illustrating the threat to financial stability that can be associated with laundering of criminal funds. Thus, the AML regime should be judged not only on the basis of the extent to which it protects the integrity of national financial systems but also the international financial system.

What are potential measures of the effectiveness of the AML regime in protecting the integrity of national and international financial systems? An examination of actual money-laundering prosecutions should provide evidence on the general use of the financial system for money laundering (especially in the placement phase) and the nature of that use. It should be possible to distinguish among institutions that are corrupt and actively solicit money-laundering business, have willing or rogue employees that provide such services on an ad hoc and non-institutional basis, or are unwitting accomplices in money-laundering operations.[11]

With respect to the integrity of the major national financial systems and the global financial system, as a first approximation the test of success should be whether major financial institutions have been linked to the first two categories of money laundering in connection with the laundering of proceeds of crimes committed within their home countries. A distinction should be made between activities and systems of banking institutions that aid and abet money laundering, and therefore can reasonably be associated with weakening the integrity of the financial systems—a relatively low hurdle—and activities and systems that fail to stop money laundering and deter the underlying crime—a much higher hurdle.

Data on money-laundering prosecutions are not generally available in the United States or in other countries on a systematic basis to permit the type of analysis one would like to conduct. However Reuter and Truman (2004, chapter 6) draw upon incomplete databases and conclude that the AML system that has been put in place in the major jurisdictions over the past 15 years has altered how banks and other core financial institutions approach their responsibilities and conduct their businesses. Banks generally take seriously the obligation of avoiding direct contact with criminal money. They have put in place reporting systems and developed monitoring techniques that make them much less attractive for money laundering. The global system that has emerged presents real obstacles to use of banks and mainstream financial institutions for placement of funds, but it is unlikely that the AML regime has made money laundering substantially more difficult or expensive. Nevertheless, the global regime appears to have largely achieved one of its primary goals: eliminating the threat from money laundering to the integrity of banking systems, at least in the major jurisdictions.

This tentative assessment should be qualified in four important respects.

- First, concern about money laundering and the integrity of financial systems focuses on placement, the first stage in the three-stage process. It is at that stage that the financial institution, and by extension its financial system, is most vulnerable to corruption and the loss of reputation. It is a different and more difficult matter for core financial institutions to prevent their involvement in money laundering at the layering or integration stages of the process.
- Second, and related to the first qualification, financial institutions could be used more extensively and effectively in connection with the investigation of enforcement of the AML regime. One example is in sting operations. Another example is in the more effective use of suspicious activity reports and similar reports.
- Third, money laundering in connection with the private banking activities of the major international banks often involves the proceeds of crimes committed outside the banks' home country and therefore only indirectly threatens the integrity of the financial systems of the home country. Nevertheless, in response to this phenomenon and motivated by similar concerns about their reputations, in October 2000 12 major private international financial institutions adopted Global Anti-Money Laundering Guidelines for Private Banking (Wolfsberg Group 2000). In addition, the new FATF Forty Recommendations (recommendation 6) calls for enhanced due diligence with respect to "politically exposed persons", the source of whose wealth may not be legitimate.

- Fourth, the tentative assessment that the global AML regime is now generally effective in protecting the integrity of the core financial systems of the major countries leaves to one side the issue of institutions at least notionally headquartered outside the major financial centres and their capacity to abuse and undermine the integrity of the global financial system. Again these institutions and jurisdictions pose less of a direct threat to the financial systems of the major countries, but the risks are not negligible, and the integrity of the core financial systems of smaller, poorer countries is relevant to them. This area, as well as the area of the proceeds of corruption that are often associated with private banking, is more germane to the role of the AML regime in targeting global "public bads"—terrorism, kleptocracy and failed states—discussed below.

The global AML regime has been successful in protecting the integrity of financial system via the core financial institutions headquartered in the major financial centres of the system but, most likely, has not reduced substantially the total volume of the proceeds of crime laundered globally. Thus the activity has been pushed into more peripheral institutions and jurisdictions, and the AML regime has expanded to pursue the phenomenon into those institutions and locations. The net effect may have been positive with respect to the goal of protecting the integrity of the core financial system in major jurisdictions but negative with respect to the achievement of other AML goals.

Controlling global "public bads"

The goals of the global AML regime include not only the reduction of crime and the protection of the core financial system, but also the control of acknowledged global "public bads", such as terrorism, corruption, kleptocracy and state failure.

Terrorism. The role of the AML regime in reducing the financing of terrorism presents special challenges with respect to the assessment of its effectiveness. In the case of terrorism financing, the resources are not laundered after the crime but beforehand to facilitate the activity. This means that much of the focus of efforts to combat terrorist financing is at the final stage of the process, in which funds are put in the hands of terrorist organizations, rather than at the placement stage in which the funds enter the financial system, which is the focus of traditional AML efforts.

The AML regime's focus with respect to the financing of terrorism is principally on prevention, in the full defensive sense of that word. Financial trails may be helpful after the terrorist act to identify and apprehend supporters of terrorism, but the goal is to prevent the acts. The prevention pillar of the regime is marginal at best as a deterrent to terrorism, though perhaps some potential offenders will be deterred by knowledge of the difficulty of successfully acquiring funds. The enforcement pillar is more relevant to the actual blocking, seizure and confiscation of resources financing terrorism.

Combating the financing of terrorism predated the tragedy of 11 September 2001 as part of the global AML regime. Summit meetings and the FATF have paid considerable attention to the subject dating back to the airline terrorist attack and crash in Lockerbie, Scotland, in December 1988. However, in the wake of 11 September, the AML regime was revitalized to block and seize funds intended to finance terrorism and to disrupt the financing of networks that support terrorists. As of March 2004, the global total that had been frozen or seized was estimated at $203 million as a result of legal action in 173 jurisdictions.[12]

In combating the financing of terrorism, the AML tools are important, but not all-powerful. The blocking or seizing of funds intended to finance terrorism are only part of the overall effort to deal with terrorism and the financing of terrorism. A 29 August 2003 press release from the US Treasury Department, commenting on a UN report on sanctions directed at blocking the flow of funds to Al Qaida, stated, "The point isn't grabbing dollars in bank accounts when freezing orders go into place, it is destroying the financial infrastructure of terrorism. That means seizing money, but it also means dismantling the channels of funding, deterring those who would give aid and support to terrorists and following the leads to terrorist cells" (US Treasury 2003).

International cooperation is crucial to the success of the AML regime in combating the financing of terrorism. Notwithstanding various statements of strong support for combating the financing of terrorism, cooperation in this complex area is only as effective as the political will to take measures that are costly or politically unpopular because they run up against domestic institutional resistance or lack support within the political elite. For example, the 2002–03 annual report of the FATF (2003a) reported that the full compliance rate with its Eight Special Recommendations on Terrorist Financing was only 75%. The average full compliance rate by FATF members with the original FATF Forty

Recommendations as of the same date was more than 90%.[13] Although there were shortfalls in compliance with each of the recommendations on terrorist financing, most frequent were failures to comply fully with those relating to wire transfers and to the ratification and implementation of UN conventions and resolutions. The first of the FATF special recommendations calls for countries to ratify and to implement fully the 1999 UN International Convention for the Suppression of the Financing of Terrorism. As of the end of March 2004, only 112 countries had ratified the convention; an additional 41 countries had signed the convention but not yet ratified it, including 6 FATF members.[14] To cover the entire 191 members of the United Nations, another 38 countries would have to accede to the convention via ratification.

As with other aspects of the AML regime, differences in legal and regulatory structure and philosophy sometimes get in the way of co-operation. For example, the *Financial Times* on 18 June 2003 reported German criticism of US and UK authorities for resisting the extension of financial supervision regulations to "underground banks", citing the *hawala* system of international money transmission as an example. The US and UK authorities are at present satisfied with applying registration, customer due diligence and suspicious activity reporting requirements to these institutions, stopping short of a full supervisory regime.[15] Such differences interfere with the establishment of a seamless global AML regime as it applies to the financing of terrorism.

In conclusion, the global AML regime has helped to combat the financing of terrorism, an undisputed global pubic bad. However it is not a magic solution to those complex issues, and measures of success are imprecise and indirect. Efforts to strengthen the global AML regime as it is applied to the financing of terrorism confront most of the same challenges of aligning different national regimes and structures as with the pursuit of other AML goals. In addition, combating the financing of terrorism involves unique difficulties because of the relatively small amounts involved and the fact that the resources need to be intercepted before the crime occurs, rather than afterwards.

Corruption and kleptocracy. Corruption is often found in relationships between the public and private sectors. Some would argue that it occurs in purely private sector activities as well.[16] Thus the World Bank defines corruption as "the abuse of public office for private gain" (IBRD 1997:8). Transparency International, the most prominent non-governmental organization that has focused on this issue, employs a less concise definition: "corruption involves behaviour on the part of officials in the public sector, whether politicians or civil servants, in which they improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them" (TI 1996, p. 7).

Corruption of a public official is connected de facto with money laundering, whether or not corruption is a predicate crime in the jurisdiction in which the corruption occurs. The public official will place his proceeds where they are relatively safe. The safe location may be a business or piece of real estate in the official's own country, but often it is in a foreign country.

Kleptocracy is corruption by high-level public officials who use their positions systematically to line their pockets directly or indirectly from the public purse. Kleptocracy is a subcategory of political corruption. Political corruption and corruption more generally are more commonly found in societies with less well developed systems of justice and limited transparency in the public and private sectors.

The prevention pillar of the AML regime can play an important role in reducing the incidence and scale of kleptocracy. For example, rigorous application of customer due diligence with respect to politically exposed persons[17] can help to limit the success of kleptocrats, since they generally have little interest in keeping their ill-gotten gains invested in their own jurisdictions, where any change in government might threaten control of those assets. In addition, the enforcement pillar can play a role as well, through the punishment of kleptocrats and the confiscation of the proceeds of their crimes. Both elements of the enforcement pillar are important because they not only punish the individuals, but also set examples for junior officials who may be tempted into similar behaviour.

A reasonable proximate measure of the effectiveness of the AML regime in dealing with kleptocracy would be the flow of convictions of kleptocrats or the amount of funds frozen and returned to their countries of origin. Unfortunately, data to construct such a measure are not currently available, and anecdotal information is uneven. One reason is the general lack of attention to the development of measures of the effectiveness of the AML regime. Various public and private international organizations have ongoing efforts to raise the profile of work against kleptocracy and corruption, but none has yet developed a comprehensive database that would permit the construction of a measure of progress in reducing kleptocracy.

Table 5.1 presents a cross-tabulation of the assessment of the seriousness of money laundering on the basis of information in the money

Table 5.1 Number of countries rated for money laundering and corruption

Corruption quintile (CPI)[a]	Money laundering rating (*INCSR*)[b] Primary concern[c]	Concern[d]	Monitored[e]	Total rated	Not rated	Total
Fifth	6	4	15	25	3	28
Fourth	6	7	15	28	0	28
Fourth to fifth	12	11	30	53	3	56
First to third	31	19	27	77	0	77
Total rated	43	30	57	130	3	133
Not rated[f]	10	20	30	60	12	72
Total	53	50	87	190	15	205

a. Corruption Perceptions Index, Transparency International. b. *International Narcotics Control Strategy Report*. c. Jurisdictions whose financial institutions engage in currency transactions involving significant amounts of proceeds of narcotics trafficking. d. Jurisdictions where the money laundering phenomenon is not considered acute. e. Jurisdictions reviewed that do not pose an immediate concern. f. Rated by the *INCSR* but not by Transparency International, including 14 dependent and autonomous territories that are rated by the *INCSR*.

Sources: US Department of State (2003) and TI (2003).

laundering and financial crimes section of the US State Department 2003 *International Narcotics Control Strategy Report* (*INCSR*) and of the assessment of the extent of corruption on the basis of the corruption perceptions index (CPI) published by Transparency International (2003). Forty-three countries are identified as of "primary money laundering concern" by the *INCSR* and are rated by Transparency International (TI). If the countries were evenly distributed across the TI quintiles, we would see 17 in the fourth or fifth quintiles instead of 12. With respect to the 30 countries identified as of "money laundering concern" by the *INCSR* and rated by TI, we find 11 rather than the expected 12 in the fourth or fifth TI quintiles. An explanation for the apparent lack of a tight association between money laundering and corruption may be that, where there is a lot of corruption, with the possible exception of corruption principally by senior government officials, the proceeds of other crimes are not safe.

The global AML regime has been slow to incorporate public corruption and, by extension, kleptocracy into its set of objectives. In the United States foreign corruption only became a predicate offence for a money-laundering prosecution with the passage of the USA Patriot Act in 2001, despite earlier executive branch proposals and pressures from other countries.

Moreover, the pursuit of kleptocracy and international bribery cases is complex and expensive. Writing for proactive and often-critical Transparency International, Heimann (2004, p. 129) comments, "Prosecutors may be reluctant to bring foreign bribery cases because they lack the professional resources to pursue complex international cases. Procedures for obtaining evidence from abroad are often cumbersome and often unproductive." He prescribes technical assistance in connection with cases in developing countries.

In the United States, the White House or the State, Treasury, Justice or Homeland Security departments each may receive requests for assistance with respect to corruption by former officials. The US government bureaucracy generally is not structured to respond quickly to such requests, producing delays that at a minimum can be politically embarrassing.[18] Nonetheless, under US law the government is constrained from responding proactively to assertions by foreign governments that various former officials were corrupt and that any assets they have in the United States should be immediately turned over to the new government of the country. Requests for assistance must contain a factual or legal basis to allow the US government to act. Requests might show, for example, some evidence that the funds were the proceeds of a US crime, which now could include corruption abroad.

In conclusion, one might hope that in the future the AML regime would be more effective in dealing with kleptocrats before and after they have left power, which would improve the anti-corruption climate generally. As part of this progress, better measures of success than surveys of corruption perceptions should be developed.

Failed or failing states. With respect to the linkage between money laundering and failed or failing states, the evidence of a consistent, tight connection again is not overwhelming. Table 5.2 provides a cross-tabulation of money-laundering concern, again using the *INCSR* ratings, with a combination of indicators of "failed" or "failing" states (see table 5.3).[19] Only 18 (35%) of the 51 politically or economically failed or failing states that the *INCSR* rated are classified as jurisdictions of "primary money-laundering concern" or "money-laundering concern" as part of that process. This percentage is less than the 52% of the 175 countries covered by both classifications that are of "primary concern" or "concern." Those failed or failing states account for 20% of the 90 countries of primary concern or of concern in the *INCSR*, less than the 29% of the 175 countries covered by both classifications that are "failed" or "failing".[20]

This lack of a tight association between money laundering and failed states should not be particularly surprising. As argued by Masciandaro and Portolano (2002), money launderers or their clients attach a high importance to keeping their money safe and would like to exploit legal

Table 5.2 **Number of countries for rated for money laundering and failures of state**

State and economic viability ratings	Money laundering rating (*INCSR*)[a] Primary concern[b]	Concern[c]	Monitored[d]	Total rated	Not rated	Total
Political viability						
Failed[e]	1	0	5	6	3	9
Failing[f]	10	4	17	31	4	35
Of which:						
Economic viability						
Failed[g]	1	0	2	3	1	4
Failing[h]	0	2	9	11	3	14
Total failed or failing	12	6	33	51	11	62
Not failed or failing	35	37	52	124	4	128
Total states	47	43	85	175	15	190
Dependent or autonomous territories	6	7	2	15	0	15
Total	53	50	87	190	15	205

a. *International Narcotics Control Strategy Report*. b. Jurisdictions whose financial institutions engage in currency transactions involving significant amounts of proceeds of narcotics trafficking. c. Jurisdictions where the money laundering phenomenon is not considered acute. d. Jurisdictions reviewed that do not pose an immediate concern. e. Rotberg combined with Polity IV; see notes a and b in table 6.3. f. Rotberg combined with Polity IV; see notes d and e in table 5.3. g. In the fifth quintile in both the Overall and the Public Sector Management and Institutions categories of the Country Policy and Institutional Assessment (CPIA) rating. h. In the fifth or fourth quintile of the Overall or Public Sector Management and Institutions categories of the Country Policy and Institutional Assessment (CPIA) rating and not failed; see note g.

Sources: IDA (2003) (using Country Policy and Institutional Assessment for allocation of IDA funds), US Department of State (2003), Rotberg (2003) and Gurr and others (2003) (Polity IV).

protections to do so. This is not likely to be the case in politically or economically failed or failing states. The only politically failed state that is rated by the *INCSR* as of primary concern is Myanmar, and the only economically failed state is Nigeria. Both have been reviewed by the FATF as part of its review of non-cooperative countries and territories. Neither has passed. Myanmar might be considered to be in a different category of rogue states: states in which there is order, perhaps, accompanied by violence, but violence inflicted by the authorities. Such states might be content to flout international norms, for example, by dealing regularly with criminal gangs that operate globally. North Korea might be considered to be in the same category.[21]

With respect to the global AML regime and failed states more broadly, there appear to be connections, but the major instruments for dealing with failed states lie outside the AML regime. At the same time,

Table 5.3 Country ratings as failed or failing states, by rating method, 2002

Country	Failed states			Failing states			Not included in CPIA List[g]
	Rotberg[a]	Polity IV[b]	CPIA[c]	Rotberg[d]	Polity IV[e]	CPIA[f]	
Afghanistan	X	X					X
Algeria					X		X
Angola	X	X	X				
Azerbaijan						X	
Bolivia				X			
Burkina Faso				X			
Burundi	X	X				X	
Cambodia				X		X	
Cameroon						X	
Chad				X		X	
Central African Republic			X				
Colombia				X	X		X
Comoros						X	
Congo, Dem. Rep. of	X	X				X	
Congo, Rep. of						X	
Djibouti						X	
Ecuador				X			X
Egypt					X		X
Fiji				X			X
Gambia						X	
Georgia				X	X	X	
Ghana				X			
Guinea				X		X	
Guinea-Bissau					X	X	
Guyana						X	
Haiti			X	X			
Indonesia				X	X		
Iran					X		X
Iraq					X		X
Israel					X		X
Kyrgyz Republic						X	
Kiribati						X	
Laos			X	X			
Lebanon				X	X		X
Liberia	X						X
Moldova				X			
Myanmar		X					X
Niger				X		X	
Nigeria			X				
Pakistan					X		
Papua New Guinea						X	
Paraguay				X			X
Philippines					X		X
Rwanda					X		
São Tomé & Principe						X	
Senegal					X		
Sierra Leone	X	X				X	
Solomon Islands			X	X			
Somalia	X	X					X
Sri Lanka				X	X		
Sudan	X	X	X				

continues

Table 5.3 Country ratings as failed or failing states, by rating method, 2002 (continued)

Country	Failed states			Failing states			Not included in CPIA List[g]
	Rotberg[a]	Polity IV[b]	CPIA[c]	Rotberg[d]	Polity IV[e]	CPIA[f]	
Thailand					X		X
Tajikistan			X	X	X		
Timor-Leste				X			X
Tonga						X	
Togo			X				
Turkey					X		X
Uganda					X		
Uzbekistan			X				
Vanuatu						X	
Zimbabwe			X		X		
Yemen						X	
Total	8	8	11	21	20	23	18

a. Failed states are tense, deeply conflicted, dangerous and contested bitterly by warring factions. b. State failure includes four types of events: revolutionary wars, ethnic wars, adverse regime changes, genocides and politicides. c. In the fifth quintile in both the Overall and the Public Sector Management and Institutions categories of the Country Policy and Institutional Assessment (CPIA) rating. d. States with one or more failed state features; see footnote a. e. Two or more temporally linked wars or crises; see footnote b. f. In the fifth or fourth quintile of the Overall or Public Sector Management and Institutions categories of the Country Policy and Institutional Assessment (CPIA) rating and not failed; see footnote c. g. Countries rated as politically failed or failing states that are not included in CPIA ratings.

Sources: IDA (2003) (using Country Policy and Institutional Assessment for allocation of IDA funds), Rotberg (2003) and Gurr and others (2003) (Polity IV).

unless the global AML regime is actively and successfully used as a prevention tool, failed states or some failing states may become substantial lacunae in the AML regime. Nigeria is a case in point. Moreover, the links between kleptocracy, money laundering and state failure appear to be stronger than those between garden-variety corruption, money laundering and state failure. This suggests deeper connections between the various global bads, which need to be studied further. It also suggests that the AML regime has a role to play in the prevention, identification, isolation and potentially the rehabilitation of failed states.

Recommendations

The global AML regime is best characterized as a global public *intermediate* good, a nascent experiment in global governance to provide the infrastructure for the provision of needed global public *final* goods. Without a strong and robust infrastructure global public final goods will be provided inefficiently or insufficiently. The global AML regime should be seen as a tool, an instrument, to achieve multiple goals: reduction of a variety of everyday crimes, protection of the integrity of national financial systems and the international financial system and control of global "public bads" such as terrorism, kleptocracy and state failure.

In this context, six categories of recommendations, covering 15 items (designated items a through o), should be considered to improve the structure and functioning of the global AML regime.

Recommendation 1: Develop quid pro quos.

Different countries in different circumstances seek different outcomes from the global AML regime. Most countries want to protect the integrity of their financial systems and recognize that international cooperation on common standards and approaches will assist them in achieving that goal. Most countries oppose terrorism and corruption, but countries may place different emphasis on these goals. Most countries want to reduce the incidence of crime, but not the same crimes.

All this suggests the need for parallel, integrated treatment of serious underlying money-laundering offences; those that are important in one jurisdiction should be accorded equivalent standing and reinforcement in other jurisdictions. The FATF has identified 20 categories of crimes (item a) that should be on the list of predicate crimes for money-laundering prosecutions, if those crimes are committed within national jurisdictions. An important step towards increased international cooperation on money laundering would be to treat all of those categories of crimes equivalently, whether the offence is committed outside or within a country and the laundering of the proceeds occurs within its jurisdiction.[22]

In addition, laundering the proceeds of tax evasion (item b) is not a crime in most jurisdictions, and the general level of international cooperation on tax evasion is very low. Although tax evasion is not a predicate offence for money-laundering prosecution under US law (other than failure to pay taxes on the proceeds of a crime), its absence is not regarded as an impediment to an effective US AML regime. However the absence of foreign tax evasion as a predicate offence for money-laundering prosecution under US law is a frequently cited impediment to international cooperation and therefore becomes a barrier to US leadership and international cooperation. In private conversations Latin American leaders often complain about US insistence on issues that the United States considers important, but a lack of cooperation on issues of importance to them, such as evasion of taxes on assets held abroad. The US law should be changed so that tax evasion, whether at home or abroad, becomes a predicate offence for a money-laundering prosecution, and similar changes should be made in the laws of other countries.

As part of a broader quid pro quo for addressing US priorities in other areas, such as terrorism, the United States should be more forthcoming in helping to enforce the tax laws of other countries. Though macroeconomic policy failures by the local authorities in Latin America and elsewhere often provide substantial inducement for capital flight, it is also the case that the United States appropriately is regarded as one of the leading tax havens contributing to fiscal problems in other countries. The interaction of capital flight and tax evasion is a particular problem where governments have difficulty raising adequate revenues to finance their expenditures, resulting in a run up of unsustainable stocks of sovereign debt to foreign and domestic holders. Critics counter that many countries' tax laws are flawed. What country's are not? Nevertheless, one approach might be to condition increased cooperation in the tax area upon criteria that apply to the structure and efficiency of the other country's tax system.

Recommendation 2: Emphasize cooperation on corruption.

Corruption is increasingly recognized as a global "public bad". The global AML regime should emphasize it more. One relatively weak test of progress on international cooperation on money laundering will be the UN Convention Against Corruption (item c). To be effective it must be ratified by the major nations, many of which will have to make changes in their domestic legislation, and its provisions must be activated, for example, with respect to the recovery of assets. A stronger test would be if international cooperation actually increases as a result of the convention.

Another related area is the establishment of global standards with respect to asset freezes and forfeiture (item d), so that such actions are not only internationally coordinated but also comprehensive in their effect. A third area is extradition (item e) where special or streamlined procedures might be agreed internationally in connection with certain money-laundering offences, such as the FATF's designated 20 categories. Members of the European Union are actively considering implementing such procedures in connection with a specified list of crimes.

Recommendation 3: Develop global AML strategies.

Progress in further developing the global AML regime to advance other objectives will require ongoing international cooperation to establish consensus on global strategies (item f) that adequately serve the disparate needs of the international community. The intensified effort since 11 September 2001 to combat the financing of terrorism illustrates both the potential for focusing the tools of the AML regime on a particular objective and the pitfalls associated with a failure to recognize that some countries consider other objectives to be of equal or greater importance.

The global AML regime should evolve, in particular, with respect to enforcement, which tends to be restricted by tensions and differences between national systems of criminal justice. For example, in the area of law enforcement cooperation (item g), more streamlined information sharing in money-laundering cases should be established between law enforcement authorities. Now, cumbersome multistep processes required by existing multilateral legal-assistance arrangements often mean that diplomatic channels have to be used to share information.

This recommendation and several others raise the question of what body should be in charge of the global AML regime (item h) and its improvement. Among the candidates are the FATF, the IMF, the World Bank, the United Nations, or a new international organization.

The FATF has been remarkably successful in establishing within only 16 years an accepted set of international AML standards.[23] Its process of "naming and shaming" jurisdictions that FATF members judged were deficient in establishing and implementing national AML regimes, while controversial, has achieved a high level of pro forma compliance. Most of the major jurisdictions are full members of the FATF. The exceptions are China and India, and they have been targeted for membership as soon as their national AML regimes are brought up to FATF standards. China is now an observer in the FATF.

The IMF and World Bank have the advantage of being near-universal organizations in their memberships, and they have been persuaded by the G-7 to take on permanently a much larger role in the supervision of compliance with the AML regime. However, to date, they have not played a major role in shaping or reshaping the regime.

The United Nations has a lot of ongoing activities in AML-related areas, such as corruption, terrorism and drugs. However it is not widely respected as an action-oriented organization.

The possibility of a new international organization to deal with the complex area of money laundering and the related multiple goals of the global AML regime is not particularly attractive. New organizations tend to deliver substantially less than they promise.

Therefore, the best approach would be to work through a combination of existing organizations to develop global anti–money-laundering strategies. For example, a draft strategy might be prepared by the FATF, reviewed by the IMF and World Bank and endorsed by the United Nations.

Recommendation 4: Provide financial as well as technical assistance.

It is an article of faith to the authorities in industrial countries that all nations need to have effective AML regimes. No doubt that is desirable, but resources are scarce. Moreover, the global threat posed by weaknesses in very poor countries may be quite minor, and complete convergence of national AML regimes is not necessary to achieve an effective global regime. The trick is to identify weaknesses that need to be addressed and regimes that need to be upgraded before they become major problems for the system as a whole.

Differences in regulatory philosophy tend to impede international cooperation. Resource limitations, however, are relevant, too, with respect to choice of objectives for the global AML regime and the allocation of scarce governmental or private resources generally to AML goals. Limiting money laundering was a high-profile public good in the United States even before 11 September 2001, but in some other jurisdictions it was regarded then as now as an unaffordable luxury.

Although the financial and non-financial costs of the current global AML regime are most likely bearable for advanced economies, they loom larger for less developed economies. The financial costs for countries and institutions are largely fixed costs, such as the cost of the addition of new reporting requirements by adapting existing data management systems. These fixed costs are more difficult for smaller countries and institutions to absorb. The non-financial costs (for example, associated with an increased burden of regulation) are often associated with dead-weight losses that are more burdensome for poorer countries.

This situation argues for increased technical assistance (item i) financed by the countries that value more highly the benefits of the AML regime. It also argues for direct financial assistance (item j) to countries to increase the probability of effective implementation aimed a specific task, such as the conviction of kleptocrats.

If the mature industrial countries with well developed AML regimes help to pay for the improvement and implementation of AML regimes in poorer countries, for example, through a trust fund administered by the World Bank, this might advance the global project. Care would have to be taken to ensure that the expenditures being financed were additional and effective. This is an area where the World Bank has developed considerable expertise and a favourable reputation in recent years through its reviews of public expenditures. Consideration should be given to the use of matching grants to the poorest countries.

Recommendation 5: Develop a global report on money laundering.

Consideration should be given to the production of a global equivalent of the US State Department's annual *International Narcotics Control Strategy Report* on money laundering. The *INCSR* identifies nations that the United States believes have major money-laundering problems. Though the concern of the report is with money laundering as it facilitates drug trafficking, the report correctly notes that this activity cannot be separated from money laundering more generally.

The *INCSR*, although useful for certain analytical and other purposes, represents only a US perspective. A report from an international agency, perhaps the United Nations Office on Drugs and Crime, which has itself no actual regulatory responsibility, is a possibility. The global report on money laundering (item k) could be compiled every two or three years and rate nations around the world in terms of the extent and nature of their money-laundering problems. It would serve a very useful educational function and contribute to better analyses of money laundering and improvements in its control. These ratings could draw upon, but be separate from, the IMF/World Bank reviews, as well as the FATF's mutual assessments.

Such a report might assist in the development of a global anti–money-laundering strategy, as proposed in recommendation 3. If a UN agency developed it, rather than the FATF, the IMF or the World Bank, it would provide additional credibility to the report and help to reinforce the cooperative nature of the AML regime.

Recommendation 6: Develop a cooperative research strategy.

The empirical and analytical foundations of the global AML regime leave something to be desired. National authorities should be encouraged to cooperate more on gathering and analysing information about prosecutions and investigations of money laundering. Global institutions should take the lead in sponsoring research in this area.

A cooperative research strategy should cover the following four topics at a minimum: First, it should seek to develop a global database (item l) on money-laundering investigations and prosecutions. Second, to help evaluate progress in protecting the integrity of the financial system (item m), an important dimension of the database should focus on the roles of financial institutions in those cases with respect to their involvement in institutional solicitation, solicitation by a rogue officer or unwitting participation or negligence. Third, to focus on kleptocrats (item n), another dimension of the database should assemble systematic information on the convictions of high-level individuals for corruption and the amounts of funds frozen and returned to their countries of origin. Finally, to help to allocate the costs of developing and maintaining the global AML regime, a cooperative research programme should focus on the costs of establishing and maintaining an adequate AML regime (item o) in various countries.

Such a cooperative research strategy would complement recommendation 3 for the development of global AML strategies and recommendation 5 for a periodic report on money laundering. To move this recommendation forward the major countries should endorse joint research projects that might be sponsored by the FATF. The IMF and especially the World Bank, which has an extensive programme of research on corruption, could also play an important role in implementing this recommendation.

Table 5.4 **Summary of recommendations and related items, by priority and costs**

Recommendation and related item	Priority[a]	Financial cost[b]	Political cost[c]
1. Quid pro quos			
(a) 20 categories	1	T	M
(b) Tax evasion	1	T	H
2. Corruption			
(c) UN Convention	1	T	L
(d) Freezes and forfeitures	4	T	H
(e) Extradition	4	T	H
3. Global strategies			
(f) Consensus	3	T	M
(g) Law enforcement	4	M	H
(h) Who's in charge	2	T	H
4. Assistance			
(i) Technical	2	M	M
(j) Financial	1	L	M
5. Global AML report			
(k) Report	4	T	M
6. Cooperative research			
(l) Global database	3	M	M
(m) Financial system integrity	3	T	M
(n) Kleptocrats	2	T	L
(o) Costs	3	M	M

a. Highest priority (1); very desirable (2); important (3); worthwhile (4). b. Large (L); moderate (M); trivial (T). c. High (H); medium (M); low (L).

How to evaluate benefits and costs

It would be useful to have some sense of the relative importance of the six recommendations (including the 15 individual items) and the financial and political costs associated with each of them. To that end, the concluding section of this contribution offers a qualitative evaluation. The items are classified in four categories from highest priority to worthwhile. For each item, the financial costs are classified as large, moderate, or trivial, and the political costs are classified as high, medium, or low. Table 5.4 provides a summary.

Highest-priority items

Four highest-priority items should receive the greatest emphasis in the ongoing effort to make progress with respect to the various objectives of the global AML regime.

- *Item a: Incorporate 20 categories of predicate crime into national laws.* To promote more international cooperation through the mechanism of quid pro quos, highest priority should be attached to encouraging all countries not only to incorporate into their national laws the 20 categories of predicate crimes that the FATF has indicated should be covered when the crimes are committed domestically, but also to incorporate those underlying offences into national laws when the crimes are committed in foreign jurisdictions. Doing so would involve essentially no financial costs, but a medium amount of political cost would be involved, because it is often difficult to pass legislation in this area.

- *Item b: Make tax evasion a predicate crime.* Similarly, making tax evasion (domestic and foreign) a predicate crime for prosecution for money laundering would significantly boost international cooperation on the global AML regime. Again, the financial costs of doing so would be trivial. However, the political costs would be very high.
- *Item c: Ratify the UN Convention Against Corruption.* International cooperation on the global AML regime would also be promoted, along with progress in addressing one of the global "public bads" at which the regime is directed (corruption), by the prompt ratification of the UN Convention Against Corruption. The associated financial costs would be trivial, and the political costs would also be low.
- *Item j: Provide financial assistance to poor countries.* Helping poor countries establish and implement their AML regimes could pay large dividends not only by increasing the robustness of the global regime, but also by promoting the rule of law generally. Although the political costs of implementing this recommendation would be in the medium range, the financial costs could be large. Recall the crude estimate (Reuter and Truman 2004) of the gross financial costs in 2003 of the AML regime in the United States—$7 billion. If we scale that figure by global GDP (at current exchange rates), we obtain an estimate of $23.3 billion as the gross financial costs of a global regime of at least the quality of the US regime. On the same basis, the annual gross financial costs to the poorest countries, those eligible to borrow from the International Development Association, can be estimated at $816 million.[24] Even if matching grants covered only 90% of the direct AML regime costs to the governments of these poor-

est countries, a rough estimate of the total is $315 million a year.[25] Moreover, consideration would have to be given to how to offset some of the costs to private sector enterprises, which would likely face higher costs in connection with access to the financial system.

Very desirable items

Three items can be identified as very desirable in enhancing the global AML regime.

- *Item i: Provide technical assistance.* Technical assistance is critical for a strong global AML regime. Today, technical assistance is being provided bilaterally, coordinated through the FATF, and by the World Bank and the IMF. No global estimate of the costs of this assistance is readily available. However there is little doubt that a moderate increase in such assistance, perhaps $150 million a year, would be useful. It would require a medium amount of political cost to come up with an additional amount of technical assistance on this order of magnitude.
- *Item h: Decide who's in charge.* Although the management of the development of the global AML regime has proceeded reasonably smoothly over the past 20 years and more intensively over the past half dozen years, there could be considerable benefit in trying to reach a consensus on who should be in charge. The associated turf battles, however, could involve large political costs even if the financial costs were small.
- *Item n: Identify kleptocrats.* Kleptocrats, in particular, and corruption, in general, are the new frontier of the global AML regime. Assessing the contribution of the regime to achieving the goal of controlling this global "public bad" is complicated by the lack of a comprehensive database. If the World Bank as part of its anticorruption programme would undertake to develop, maintain and publicize such a database, drawing initially on publicly available information, the collective benefits would be substantial, and the financial and political costs would be small. The political costs would rise if this research project sought to exploit information from non-public sources.

Important items

Four items can be identified as important to the development of a more effective global AML regime.

- *Item f: Build consensus on a global strategy.* The development and usefulness of the global AML regime would be enhanced if it were possible from time to time to establish consensus on a global strategy that meets the disparate needs of the international community in this area. A prior consensus on who is in charge would advance this effort. The aim should be to establish priorities for the use and development of the AML regime as a tool to achieve agreed objectives. The financial costs of developing and updating such a strategy should be trivial; the political costs would be in the medium range.
- *Items l, m and o: Support cooperative research.* Three parts of a cooperative research strategy on money laundering are important to the future development and use of the regime: development of a global database of money-laundering investigations and prosecutions; inclusion in that effort of a sub-database on financial institutions' involvement in such cases to facilitate the monitoring of efforts to protect the integrity of the financial system; and intensive, cooperative research into the costs of establishing and maintaining an adequate global AML regime. The first and last items are likely to involve a moderate amount of financial costs by the standards of research programmes, but in the context of a general database effort, inclusion of information on the involvement of core financial institutions in the activity should be trivial. The establishment of such a research programme might involve a medium amount of political costs because of the need for effective cooperation.

Worthwhile items

Four items can be identified that are likely to contribute less, especially over the next few years, to the development of a global AML regime, but nevertheless would be worth pursuing.

- *Item g: Support cooperation in law enforcement.* The enforcement pillar of national AML regimes and, in particular, the global AML regime is underdeveloped. Efforts to increase cooperation among law enforcement agencies would strengthen enforcement. There would, no doubt, be moderate financial costs involved as systems are changed and upgraded, and the political costs of this type of activity could well be high, but the eventual payoffs could be substantial.

- *Items d and e: Develop standards for freezes, forfeitures and extradition.* Two specific areas of international law-enforcement cooperation would be aided by institutional development: the development of global standards for asset freezes and forfeitures and the streamlining of procedures for extradition in money-laundering cases. The financial costs of these improvements would be trivial, but the political costs are probably high, judging from the difficulty in making progress in related areas.
- *Item k: Report regularly on progress.* It would be worthwhile to compile a global report on money laundering every two of three years to help evaluate and guide the development of the global AML regime. The financial costs of preparing such a report by an appropriate body, such as a UN agency, would be trivial. The obstacles are likely to be political at a medium level.

Notes

1. This schematic conceptualization of the AML regime is presented in greater detail in Reuter and Truman (2004). To my knowledge it has not been used elsewhere, but we think it captures well the basic structure of the AML regime.
2. Both reasons explain why the US AML regime has not to date been applied to lawyers and accountants.
3. Corruption abroad was only added to the US list of predicate crimes for a money-laundering prosecution with the passage of the USA Patriot Act in 2001.
4. This element is somewhat controversial. Criminal forfeiture had been outlawed by Congress in 1790 and was not reintroduced until 1970.
5. FATF's mandate was extended for an additional five years in 1994 and 1999 and extended further for a record eight years on 24 May 2004.
6. In 1991 the European Community adopted its first directive on money laundering that sought to establish minimum standards throughout what is now known as the European Union. It has been characterized (Stessens 2000) as motivated in part by other global attempts to

address the money-laundering phenomenon and also by concerns that money launderers or criminals would take advantage of the increasingly free flow of capital and financial services throughout the EU and the associated need to establish a level playing field in Europe. Gilmore (1999) stresses the particular challenge that human rights concerns have posed for the construction of an AML regime in Europe.

7. Forty-six jurisdictions have been reviewed by the FATF as part of its NCCT process. Half of them (23) failed their initial reviews.

8. Myanmar.

9. The IMF had already accepted the FATF's AML/CTF standards as one of its 12 internationally recognized standards and codes.

10. The reviews for Bangladesh, Honduras, Israel and Tanzania had not been published.

11. In the third category—unwitting accomplices—one might want to distinguish institutions whose internal AML controls are deficient, which may contribute to their unwitting facilitation of the money laundering.

12. This is the sum of blocked or frozen plus seized or confiscated funds; funds are first blocked or frozen and later may be seized or confiscated through a separate legal proceeding. There may be some double counting in the data presented because they draw on a number of non-US sources. Some funds have been released to fund government activities (for example, the total includes $27.7 million released to Afghanistan). The total also includes $64 million that have been seized, with the balance frozen. The data are from the US Treasury, based on Zarate (2004).

13. The IMF (2004) reported on its pilot project assessments with the World Bank of compliance with standards on anti–money laundering and combating terrorism financing that compliance with the original FATF Forty Recommendations on AML was much higher than with the newer FATF Eight Special Recommendations on Terrorist Financing, noting that frequently necessary legislation had not yet been adopted.

14. The FATF members that had not ratified the convention were Argentina, Belgium, Brazil, Germany, Greece and Ireland. The United States, leading the war on terrorism after 11 September 2001, did not itself ratify the convention until 26 June 2002.

15. Similar differences in regulatory philosophy underlie attitudes toward the regulation of hedge funds in Germany and France, compared with the United States and United Kingdom.

16. The new UN Convention Against Corruption does not cover private to private sector corruption or the financing of political policies, to the disappointment of some private sector observers.

17. The FATF defines politically exposed persons as "individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, important political party officials" (FATF 2003b).

18. The US government in late 1999 received a publicized request by Indonesia for assistance in finding the assets of former president Suharto. It went unanswered for 10 months. The eventual US response was that the Indonesian government would have to provide more detailed information if the US government was to be of any assistance.

19. Politically failed or failing states are identified either in Rotberg (2003) or Gurr and others (2003). Economically failed or failing states are those in the fourth or fifth quintiles of the 2003 Country Policy and Institutional Assessment (CIPA) by the International Development Association (IDA 2003) in terms of their overall CIPA rating or their rating on public-sector management and institutions.

20. This calculation excludes dependent or autonomous territories that are covered by the *INCSR*, but presumptively cannot be full-fledged failed or failing states, such as the Cayman Islands and the Isle of Man.

21. North Korea did not make the lists of failed or failing states as of 2002. Along with South Korea, it is rated by *INCSR* as a country of "concern" with respect to money laundering.

22. This is not the case today, for example, in the United States for 7 of the 20 categories: sexual exploitation, trafficking in humans, forgery, counterfeiting of currency, counterfeiting of products, environmental crime and insider trading and market manipulation.

23. The FATF has just completed a review of its AML standards, and it did so through a relatively open process that included consultations with a number of FATF-style regional bodies. Those bodies are also conducting peer reviews. It would be reasonable to follow this pattern when the Forty Recommendations come up for review or adjustment, but that is likely to be at least a decade from now.

24. US GDP in 2003 was 30% of global GDP. The combined GDP of the 81 IDA-eligible countries was 3.5% of the world total.

25. Reuter and Truman's crude estimate of the gross financial costs of the AML regime to all levels of the US government is $3 billion a year in 2003, implying a global cost of a US-type regime of $10 billion and a cost for the poorest countries of $350 million.

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