

In this issue

37
New Basel capital
adequacy standards

37
El-Erian: capital
market trends

42
Schinasi: OTC deriv-
atives markets

44
Corden: exchange
rate regimes in
developing countries

46
In memoriam:
Sir Alan Whittome

47
Fischer:
globalization
and Africa

49
IMF technical
assistance

51
Emerging markets
in global financial
system

and...

48
Selected IMF rates

49
Recent publications

50
New on the web

New capital accord

Basel Committee presents proposals for new capital adequacy standards for banks

Historically, banks incurred credit risk through direct loans and relationship financing of their customers. Setting capital requirements for these types of credit risk was relatively straightforward and worked fairly smoothly under the 1988 Capital Accord of the Basel Committee on Banking Supervision (BCBS). However, since 1988, sweeping financial market changes, including the development of secondary markets in which credit risk can be traded, have overtaken the basic credit-risk measurement scheme that determines bank capital requirements. Advances in understanding and modeling credit risk have facilitated the design of new financial instruments and pricing techniques that

Photo Not Available

William J. McDonough, Chair of the Basel Committee on Banking Supervision.

spurred the development of a secondary market.

To address these market changes, on January 16, the BCBS, under the chairmanship of William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, issued a new set of consultative documents on capital adequacy standards for banks. The consultative period ends May 31, 2001, and a final set of capital adequacy standards is expected to be ready around the end of 2001, to become effective in 2004.

Background

The Basel Capital Accord of 1988 created a minimum capitalization standard for internationally active banks under which capital

(Please turn to the following page)

Mohamed El-Erian

Emerging markets performed strongly in 2000, could face bumpy though rewarding ride in 2001

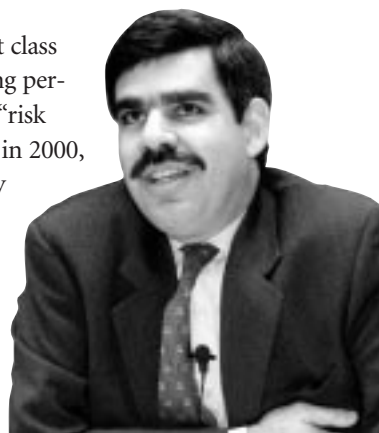
In an IMF Institute seminar for staff on January 19, Mohamed A. El-Erian, a managing director at the Pacific International Management Company (PIMCO) and former IMF staff member, offered his view on trends in capital markets for emerging economies. His presentation highlighted the markets' solid performance in 2000, notwithstanding a fluid international environment. For 2001, he singled out the U.S. economy and emerging economies' internal fundamentals as two key determinants of performance.

In his opening remarks, El-Erian noted that the average spread between emerging market bonds and U.S. treasury securities was about 750 basis points at both the beginning and end of 2000. This contrasted greatly with the experience of 1998, when spreads were highly volatile, and 1999, when spreads tightened

significantly, raising returns to investors in emerging market securities. Indeed, during 1999–2000, he said, emerging market debt outperformed all other fixed-income asset classes.

Interestingly, the asset class shared the top-ranking performance with other "risk assets" in 1999, while in 2000, it was in the company of bonds (such as U.S. treasury bonds) at the other end of the risk spectrum. El-Erian also observed that the emerging market

(Continued on page 40)



Mohamed El-Erian

(Continued from front page) requirements are based on a limited number of risk categories. The 1988 accord served two main purposes: first, to promote equal competitive conditions across countries for internationally active banks, and, second, to enhance the financial resilience of these banks. Ultimately, more than 100 countries adopted the Basel approach. Although the 1988 accord was intended originally for internationally active banks, the framework has been seen as applicable to all banks worldwide.

Among changes since the original Basel Accord, banks now routinely securitize their loan portfolios, essentially selling credit risk in the secondary market instead of retaining it in the form of loans on their balance sheets. Credit derivatives—specialized contracts that allow third parties to trade counterparty risk—provide banks with opportunities to fine-tune credit exposures that they ultimately decide to retain. The development of these types of instruments and markets—largely unanticipated when the original Basel Accord was designed—is perhaps the most important change prompting a revision of the accord.

Moreover, market experience since the 1988 Basel Accord has highlighted the potential shortcoming of an exclusive supervisory focus on capital rules. With the development of derivatives markets and global finance opportunities for banks' customers, as well as increased intragroup connections within banks' corporate environments, it has become increasingly difficult to supervise banks through rigid capital guidelines alone. The interaction between the current limited system of credit-risk categorization and advances in the ability to trade credit risk on secondary markets has created incentives for banks to sell their high-quality credit exposures. Thus, banks are at risk of retaining exposures to credits that, when held in isolation, could lead to undercapitalization under existing guidelines. As a consequence, the prudential value of the 1988 capital adequacy ratio has eroded in countries with advanced financial markets. Moreover, recent experiences in the crisis countries of the late 1990s have shown that the indicative power of the 1988 capital adequacy ratio in these countries was largely illusory. Mainly as a result of insufficient loan loss provisions, many banks in these countries reported comfortable capital adequacy ratios shortly before the onset of the crisis.

New proposals

The current proposals—made up of three sections, or “pillars”—are a major advance over the 1988 accord. Pillar I is intended to link capital requirements more closely to actual risk; pillar II strengthens the supervisory process for enforcing capital standards; and pillar III seeks to enhance the effectiveness of market disci-

pline through uniform bank disclosure. Pillars II and III formally highlight what banking supervisors have always maintained: that bank capital regulations are only one part of a well-constructed system of prudential oversight. While the proposals are called a “capital” accord, their scope is significantly broader than simply capital adequacy standards.

Pillar I. This section provides a finer grid of capital adequacy requirements for different types of risks. Banks are offered a choice, depending on the level of sophistication of their risk-assessment and risk-management systems (and subject to supervisory approval), between the so-called standardized approach, which relies on third-party ratings to assess credit risk, and an “internal ratings based” (IRB) approach, which allows banks to use their own risk management systems (after approval by the supervisors) to rate the credit risk of their counterparties.

Under the standardized approach, banks are required to apply predetermined risk weights for various types of counterparties, such as corporate borrowers, sovereign borrowers, and other banks, based on external assessments, such as rating agencies. The risk weights determine the capital required for an exposure to a counterparty. Higher risk weights imply a higher required capitalization. The new proposal expands the range of possible capital requirements that could be assigned to different types of exposure and refines the categorization system that is used to grade counterparties.

The proposal significantly alters the magnitude of the capital requirements and the system used to classify corporate credits. For example, in contrast to the 1988 accord, which had a maximum credit-risk capital requirement of 8 percent (a 100 percent risk weight), under the new proposal capital requirements could be as high as 12 percent for a counterparty with a poor credit standing (a risk weight of 150 percent). However, high-quality corporate credits receive a more favorable risk weight, and capital requirements for such exposures can drop from 8 percent to 1.6 percent under the new proposal.

The new proposal offers less sophisticated banks an expanded standardized system for classifying bank credits and offers banks with more robust risk-management systems an IRB option in which banks' internal ratings systems can be used to classify bank credits and set capital requirements. The IRB option offers more flexibility, in that banks can choose between a “foundation” and an “advanced” approach. Banks judged to have relatively sophisticated risk-management tools are allowed more autonomy in setting their own capital requirements. For instance, under the advanced IRB approach, more reliance is placed on banks' own estimates of potential credit-risk exposures. To qualify for the IRB, a bank's risk-

management systems will need to be assessed and found adequate by the supervisory authorities.

The new proposal may have important implications for some sovereign borrowers, since it abandons the distinction between Organization for Economic Cooperation and Development (OECD) and non-OECD countries as a basis for weighting sovereign risk and links capital requirements to external sovereign risk ratings. Under the new proposal, exposures to highly rated non-OECD borrowers could incur capital requirements of 0 percent rather than the 8 percent requirement under the existing system. Conversely, exposures to weakly rated OECD countries would face higher capital requirements.

As with sovereign exposures, the procedure for classifying bank exposures would also change. While the old bank classification system is based on whether the home country is an OECD member, the proposed new scheme would be based on external credit ratings. The new proposal includes alternatives under which a bank's risk weight could be linked to the country's sovereign risk rating or classified according to its own independent credit ratings. The new ratings-based system has the potential to change the capital requirements for exposure to banks in many cases. The new proposal also recognizes more fully modern credit-risk mitigation techniques that were not widely practiced by banks at the time of the original Basel Accord and includes measures designed to capture the effects of collateral, loan securitization, and credit derivatives.

By refining the guidelines for categorizing risk exposures and recognizing advances in credit-risk management, pillar I should alter the regulatory balance and encourage banks to maintain higher-quality credit exposures. It moves away from relatively mechanical capital assessments and creates incentives for banks to develop more precise risk-assessment methods. Furthermore, by modifying the treatment of sovereign and individual bank credit risk, the proposal recognizes the information obtained from external ratings and export credit agencies. The new system reflects a more risk-sensitive approach than the existing classification system.

The proposal recognizes that supervisors are not the only ones trying to assess the quality of banks' credit exposures. Internationally recognized credit ratings agencies and banks themselves have long been involved in credit risk analysis, but these efforts have never before been factored into supervisory capital adequacy requirements. Clearly, the reliance on external ratings and banks' own systems implies new sources of risk and uncertainty in the supervisory process. The "science" of credit-risk measurement is still young and unproven over a full credit cycle, and banks' incentives remain fundamentally different from those of depositors and bank supervisors. Much attention will need to be given to the assessments of banks' internal systems.

The proposal raises issues for supervisors whose banks are not as advanced as those in the most developed money centers. Countries that are currently struggling to meet the present supervisory standards—for instance, as laid down in the Basel Core Principles for Effective Banking Supervision—will need time to develop the necessary skills. The question arises whether the banks in those countries will be able to achieve the economies of scale needed to invest in sophisticated risk-management systems or whether resources are more appropriately directed at addressing more fundamental shortcomings. For countries that need more time, the proposals allow a phasing-in period of another three years after 2004, after which the new proposals are supposed to be implemented.

Pillar II. This focuses on the supervisory process. Supervisors will take more responsibility for reviewing how well banks assess their capital adequacy needs, and their assessment will not stop at the review of a number of simple quantitative standards. This pillar highlights the responsibility of supervisors to become fully conversant with risk-management techniques as used by the banks in "real life."

The proposals set out four key principles of supervisory review. First, banks must be able to relate their capital needs to their risk profile and must have a strategy to maintain capital at the appropriate level. Second, supervisors must review these arrangements and take action if they find weaknesses in a bank's capital plan. Third, banks should operate at above-minimum capital levels, and supervisors should have the power to require above-minimum capital levels. Finally, supervisors should intervene before capital falls below the minimum.

Pillar III. This reinforces market discipline by specifying what information banks must disclose. If

Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision, established in 1974, consists of senior banking supervisory officials from the Group of 10 industrial countries, as well as Luxembourg and Switzerland, and maintains close links with supervisory agencies in other parts of the world through a network of regional groupings. It also specifically includes representatives from other countries in the consultative process with regard to the new capital proposals. It is hoped that, as with the 1988 accord, the new capital adequacy rules will receive worldwide applicability.

The Basel Committee, which has a permanent secretariat at the Bank for International Settlements, is chaired by William J. McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York.

bank funding costs reflect the soundness of bank management, enforced disclosure will encourage good risk-management practices and more effective supervision. The proposals ask for additional input from the financial sector on the necessary information for meaningful disclosure. Minimum, or “core,” disclosure would encompass, for instance, detailed information on the controlling entities in a banking group, the amount of paid-up capital, disclosed reserves, minority interests, provisions for credit losses, and the composition of capital. Also, banks would need to disclose detailed information on credit exposures, including geographical breakdowns, sectoral breakdowns, volume of impaired loans by area and sector, credit risk and impaired asset management techniques, credit-risk mitigation strategies, and market risk management.

Implications for the IMF

The use of ratings, internal as well as external, will be a challenge to supervisors, who will need to validate their robustness. The effectiveness of the proposed system depends heavily on the expertise of bank management and bank supervisors, and thus provides a strong incentive for improving the quality of bank management and supervision. The system also offers the promise of greatly improved transparency of bank operations. These changes, if enacted and effectively implemented, will help improve the stability of banks

and other institutions that adopt these standards. In the meantime, many countries will need to invest considerable resources in staff, training, and information technology systems to implement these proposals. Countries are likely to request the IMF’s help in understanding and implementing elements of the new accord, given that many countries still have trouble meeting the much more straightforward requirements of the existing Capital Accord and the Basel Core Principles.

As the sophistication of banks and capital market participants increases, supervision and regulation must evolve and adapt. As market participants rely on more quantitative and sophisticated risk assessments, so must supervisors. In many countries, supervisors and banks alike will need to evolve in the interests of better-quality domestic and cross-border financial intermediation and enhanced financial stability. These processes will take much time and effort, and the IMF will need to be ready to help its members. The year 2004 is not far off, and some countries may wish to start applying the new framework well before then. ■

Jan van der Vossen
IMF Monetary and Exchange Affairs Department

For more information on the new proposals, see the Basel Committee’s website at www.bis.org/publ/index.htm.

El-Erian discusses prospects for emerging markets

(Continued from front page) rally in 2000 was broadly based, with only the Philippines and Turkey registering negative returns for the year.

Emerging markets in 2000

No single theme dominated market developments for the emerging economy asset class in 2000, according to El-Erian. The good performance of emerging market securities, he argued, reflected improved economic policies in many countries, supported by the countries’ enhanced liability management, a generally benign external environment, and the IMF’s rapid and massive emergency support for Argentina and Turkey (see *IMF Survey*, November 20, page 372, and December 11, 2000, page 385).

El-Erian noted that a growing number of countries, led by Brazil and Mexico, conducted appropriate liability management operations in 2000. These operations resulted in net present value gains, improved maturity profiles, and a de facto stabilization of their yield curves. Most notable was Mexico’s success in buying back Brady bonds. This reduced Mexico’s cost of borrowing and generated large fiscal savings. El-

Erian predicted that liability management of this sort would become an increasingly important policy tool and speculated that IMF mission teams would more often raise this issue with country authorities during consultations and program negotiations. At the same time, he warned against the indiscriminate use of debt exchanges, noting that ill-structured operations could worsen creditworthiness in some cases.

El-Erian also acknowledged the favorable impact of a positive international economic environment. Strong growth in the United States contributed to demand for exports from emerging market countries. Many emerging market countries also became more attractive to investors, as acceptance of the “new economy” paradigm led investors to anticipate higher productivity growth and increased exports. Moreover, positive rating announcements by services such as Moody’s and Standard & Poor’s outweighed negative ones by four to one for all emerging market countries.

Finally, in El-Erian’s view, the IMF’s quick and forceful support for Argentina and Turkey, by stabilizing the market and containing the risk of adverse contagion, helped the asset class’s returns in 2000 for

emerging market countries as a group. IMF support signaled to the financial markets that the adjustment programs under way in these countries were appropriate. Given these countries' large funding needs, IMF financial assistance also reduced their vulnerability to the vagaries of the capital markets. But the process is still not complete, El-Erian observed, and investors will be closely monitoring policy implementation and the behavior of local financial markets.

Outlook for 2001

For 2001, El-Erian projected both positive and negative trends. On the positive side, domestic economic fundamentals would continue to improve in many emerging market countries, although at a slower pace than in 1999 and 2000. More countries were also likely to engage in liability management. In addition, the financial market infrastructure would continue to strengthen, resulting in, among other things, better information flows. Significant cash remains on the sidelines, he added, and could be attracted to the market for bonds issued by emerging economies.

On the negative side, El-Erian believed that the international economic environment had become more uncertain. Although he believed that financial markets as a whole anticipated a "soft landing" for the U.S. economy, his views incorporated the possibility of greater "bumpiness," as well as concerns about differences in performance among economic sectors. He also expected greater pressure for governments in certain emerging market countries to intervene to support private sector companies. In addition, because spreads on emerging market securities had decreased significantly in 2000 compared with those for junk bonds, the relative attractiveness of emerging market securities had declined. It will be important, El-Erian cautioned, to monitor emerging market countries facing a challenging outlook. Common ownership of securities from these and other emerging market countries by foreign investors and an unwillingness to liquidate losing positions could lead holders to sell bonds and equities of high-performing countries as a way of maintaining liquidity. Thus, contagion could, in the short term, affect emerging market countries even without established economic linkages. Overall, El-Erian expected emerging markets in 2001 to have a "bumpy" though rewarding ride, with continued investor differentiation within and among economies.

Longer-term trends

Going beyond 2001, El-Erian expected several trends—in addition to greater use of liability management—to become increasingly important. First, he cited a growing emphasis on creditor rights, as bondholders, reacting to Ecuador's attempt at selective

default, moved to be better heard. Second, he expected a strengthening of domestic financial markets, as a way of establishing more robust multi-currency yield curves. And, third, he foresaw a move toward greater selectivity in financial markets, as investors increasingly viewed countries individually rather than as part of the broad group of emerging market economies.

Turning to the implications for investment strategy, El-Erian argued that the long-term forecast warranted a significant allocation of investment funds to emerging markets. At the same time, the fluid international situation and the risk of specific credit events called for meaningful differentiation among countries. This differentiation would entail focusing on investments in "higher-quality" countries—countries with solid macroeconomic policies, a stable political situation, sufficient foreign exchange reserves to withstand an external shock, and a good debt profile (and thus the ability to survive a period in which markets are closed to their securities). Indeed, the history of the asset class confirmed that solid multiyear returns were possible by avoiding "big accidents," such as losses from the 1998 Russian default.

Participants asked El-Erian for his view on a variety of issues, including exchange rate policy and how markets view "private sector involvement" in crisis resolution. On exchange rates, El-Erian responded that financial markets generally preferred a floating exchange rate regime, because it provided a built-in correction mechanism that did not require large and politically difficult fiscal adjustments. But the markets would accommodate the use by high-inflation countries of the exchange rate as a nominal anchor for price stabilization, he said, as long as there was provision for an orderly exit mechanism. Thus, an intermediate (for example, adjustable peg) exchange rate regime seemed attractive only over a limited time period.

With regard to the private sector's involvement in crisis resolution, the market's emphasis had shifted away from targeting a guaranteed outcome to improving the process for debt workouts, should these be required. In this regard, the Ecuadoran experience had been troubling, because creditors had not been consulted, and the country had attempted to shift legal collateral, El-Erian said. ■

Joshua Greene
IMF Institute

Photo Credits: Mark Baker for Reuters, page 37; Denio Zara, Padraic Hughes, and Pedro Márquez for the IMF, pages 37, 43–44, 46–47, and 51; and World Bank pages 51–52.

OTC derivatives markets are beneficial, but can also be source of systemic risk

An Occasional Paper by a team from the IMF's Research Department highlights the need for further changes in the operation and regulation of over-the-counter (OTC) derivatives markets. Although some progress has been made in addressing the problems that surfaced during the near-collapse of the hedge fund Long-Term Capital Management (LTCM) in the fall of 1998 and the market turbulence that followed, more needs to be done. Garry Schinasi, Chief of the Capital Markets and Financial Studies Division of the Research Department, who headed the team, met with Jeremy Clift of the IMF External Relations Department to explain why.

CLIFT: What exactly are OTC derivatives and how large is the derivatives market?

SCHINASI: Derivatives are financial contracts whose value derives from underlying instruments such as bonds, equities, and other assets. They can also derive their value from price indices. Derivatives can be traded either through an organized exchange or bilaterally, which is termed over-the-counter. Exchange-traded derivatives are standardized products traded on the floor of the exchange and usually require a good faith deposit, or margin, when a contract is bought or sold. OTC derivatives, such as currency swaps and interest rate swaps, are privately negotiated bilateral agreements transacted off organized exchanges. The risks in OTC contracts are managed individually by each counterparty, rather than collectively by members of the exchange.

Global derivatives markets are large, both in absolute terms and compared with the size of the global economy and global financial markets. For example, a couple of years ago, which is the most recent data we have for both OTC and exchange-traded derivatives, average daily turnover amounted to about \$2.7 trillion. By comparison, world GDP in 1999 stood at about \$31 trillion. So the market is huge, and every 11 days it turns over the equivalent of world GDP.

CLIFT: OTC derivative instruments have helped develop more complete and efficient financial markets, but they also appear to have contributed to systemic instability. How much do we know about the impact of OTC derivatives on global financial markets?

SCHINASI: By and large, the derivatives markets are very efficient and effective in allocating capital and helping both financial and nonfinancial firms manage risk and price it properly. But these markets are relatively new.

Some would date them as little more than 10 years old in their modern form, while recognizing that derivatives in one form or another have been around since the early recorded days of Greek and Roman civilization.

So we see these markets as mostly beneficial, but they are not well understood. One area that is not well understood is how these markets have contributed to changes in systemic risk. It is not that they have increased or decreased systemic risk, but they have helped transform global finance, and as global finance has changed, so has the nature of systemic risk. Systemic events are now more likely to play out in markets rather than in financial institutions, and the risk is that a large number of financial institutions will be adversely affected simultaneously, as occurred during the LTCM problem.

CLIFT: Have we fully learned the lessons of the near-collapse of LTCM, and what more needs to be done?

SCHINASI: First, in the aftermath of the LTCM problem, many studies were completed on derivatives markets and their attendant risks. Some of the recommendations from these reports have been implemented by the private sector and by the authorities responsible for either supervising banks or for surveying markets. So that's one factor. We know a little bit more about these markets now and about where the risks are. The authorities and firms are dealing with these risks, some more aggressively and effectively than others.

Second, some major financial institutions that make these markets—that is, stand ready to buy or sell financial instruments to help create liquidity—have withdrawn capital. A withdrawal of capital means there is less scope for high leverage, and more consideration is given to pricing. And if you look at indicators of trading activity in those markets, you see somewhat lower activity, particularly on the exchanges. Spreads are higher, indicating the higher cost of doing that business because of the withdrawal of market making. And there's much less proprietary trading going on.

From this, you can infer that lessons have been learned and that market discipline has, to some extent, exacted its toll. Firms are more cautious about putting their capital into those areas of business. They are allocating their capital to either less risky or higher-return ventures on a risk-adjusted basis.

Of course, that doesn't mean there aren't risks. Our study points to a number of potential instabilities and potential weaknesses in the infrastructure. We look at what can be done to improve the identification of pri-

vate and public risks. Our recommendations cover the full spectrum of market participants, private and public, so there are things that private risk managers, senior management of the private institutions, bank supervisors, and market surveyors can do to improve the situation.

CLIFT: Some market participants believe derivatives markets dissipate shocks by facilitating hedging; others see these markets as a channel for contagion. Do you think that the markets have created something that may easily get out of control?

SCHINASI: Overall, I would say that the risks arising from the derivatives markets are lower than they were a couple of years ago, and, moving forward, we think risk management will improve. But additional improvements are essential if the risk of instability is to be reduced in global financial markets. The private sector, for example, can reduce the potential for instability through more effective incentives and market discipline, risk management, and disclosure.

Changes in prudential regulations—in particular, capital adequacy requirements—may also be necessary if market discipline does not improve. More effective monitoring of OTC derivatives markets is essential. In addition, the scarcity of reliable information about these markets must be addressed through greater market disclosure and transparency. Legal and regulatory uncertainties affecting the markets can and should also be removed.

CLIFT: Are the tools we now have to assess risk adequate for today's markets?

SCHINASI: The LTCM crisis showed that improving counterparty risk management, and risk management more generally, is essential. The 1998 turbulence could not have occurred without the buildup and concentration of counterparty risk exposures. This was caused by several factors—financial institutions made mistakes; the risk management systems they relied on were not effective in limiting their credit exposures; and counterparty, operational, and legal risks were not properly assessed, monitored, and managed. So improvement in many areas is called for.

CLIFT: How can we make OTC derivatives markets more transparent?

SCHINASI: The quality of disclosure and information needs to be significantly improved. The scarcity and asymmetry of information were revealed to be important aspects of the buildup and unwinding of positions surrounding the LTCM crisis. It is therefore essential to develop mechanisms that provide at least the minimum information needed to allow effective market discipline and effective official oversight in a way that ensures confidentiality.

CLIFT: Are you suggesting mandatory disclosure?

SCHINASI: Improved disclosure and transparency could be achieved through cooperative and coordinated disclosure by the active institutions, or through mandatory means.

CLIFT: What is the correct balance between self-regulation by the markets and official supervision?

SCHINASI: In general, while there are good reasons for public sector involvement, this does not mean a heavy hand is required. A case can be made for relying more heavily on effective market discipline. There is scope, however, for improving capital adequacy requirements, for example, and there needs to be more of a constructive dialogue between private sector participants and those responsible for safeguarding financial stability.

CLIFT: Your study mentions that outside the United States and the United Kingdom, many jurisdictions are ill suited for effective risk management. What do other industrial countries need to do to catch up with derivatives markets in terms of regulation?

SCHINASI: Well, the legal and regulatory environments for OTC derivatives are complex in the United States and the United Kingdom, but they are often considerably more complicated elsewhere. We need some standardization. For example, the same instrument might be legally defined as a swap transaction in one country, an insurance contract in a second country, and a pari-mutuel betting instrument in a third country. Market participants are making strong efforts to mitigate the legal risks, but there are limits to what the private sector can accomplish, because contracts must ultimately be enforceable in a legal system. In return for legal and regulatory certainty, the private institutions that created these decentralized OTC markets might have to alter the market structure to reduce the risks of instability. Clearinghouses are one example of what might be feasible for limiting or containing systemic risk.

CLIFT: Have the flaws you identify in banking supervision and official market surveillance been adequately addressed?

SCHINASI: While some progress is being made in specific areas related mostly to transparency, greater national, and especially international, monitoring of markets is needed. The authorities should, for example, pay closer attention to the impact of OTC derivatives activities on



Schinasi: "Overall, I would say that the risks arising from the derivatives markets are lower than they were a couple of years ago."

private risks within financial institutions and on private and systemic risk within and across markets.

CLIFT: What is the future for OTC derivatives markets?

SCHINASI: The expansion of OTC derivatives markets will likely continue to be driven by technology and enhancements to the institutional infrastructure. The large volume of trading in some products on OTC derivatives markets has led to an increasing degree of standardization—“plain vanilla” derivatives, for example. The development of electronic trading, and clearing and settlement technologies, is making it possible to increase efficiency by introducing exchange-like

trading arrangements for these products. As a result, the distinction between exchange-traded and OTC derivatives may become blurred, and OTC products may increasingly compete with and displace comparable products on derivatives exchanges. ■

Copies of IMF Occasional Paper No. 203, *Modern Banking and OTC Derivatives Markets: The Transformation of Global Finance and Its Implications for Systemic Risk*, by Garry J. Schinasi, R. Sean Craig, Burkhard Drees, and Charles Kramer, are available from the IMF's Publications Services for \$20.00 each (\$17.50 for students and academics). See page 49 for ordering details.

Exchange rate regimes

Corden says developing countries' choices vary according to specific economic circumstances

In an IMF Institute seminar held on January 22, W. Max Corden, professor of economics at the University of Melbourne (Australia) and at the Johns Hopkins School of Advanced International Studies in Washington, D.C. and a former Senior Advisor in the IMF's Research Department, discussed developing countries' choice of exchange rate regimes. Corden acknowledged that the subject had been well studied, but thought, nevertheless, that he could contribute to the discussion. Before describing individual country cases, he outlined various exchange rate regimes, classified them according to the objectives to be achieved, and raised issues that countries must consider in choosing the regime that best suits their circumstances.

The three sets of criteria that serve as frameworks for analyzing the exchange rate regimes are the real targets approach, the nominal anchor approach, and the exchange rate stability approach.

In the real targets approach, Corden said, exchange rates, supported especially by fiscal policy, are used to try to achieve real targets, such as full employment and competitiveness. The main assumption behind this approach is that a nominal exchange rate change can be translated into a real exchange rate change, at least for a time, because inflation will not erode away the nominal exchange rate change.

Under a nominal anchor approach—which Corden said was currently fashionable—the exchange rate is used to anchor the domestic inflation rate to that of the country's trading partners. It is intended to send clear and credible signals to private agents about prospects for inflation.

The exchange rate stability approach focuses on the disadvantages of floating exchange rates, which are seen as unstable.

Classification of regimes

Countries' options for exchange rate regimes range from floating arrangements at one extreme to firmly fixed arrangements at the other extreme, with the remaining regimes falling on a continuum in between. These include pegs, target zones, and fixed but adjustable rates. Corden noted that different regimes were suitable for different countries and at different times, depending on the size of the economy, level of development, degree of openness, and macroeconomic history.

A crawling peg, according to Corden, is appropriate for countries that have significant inflation compared with their trading partners, as has often been the case in Latin America. The peg can be either passive, meaning that the exchange rate is altered in light of past inflation, or active, whereby the country announces in advance the exchange rate adjustments it intends to make. Inflation can be caused by rising wages or a rising money supply—in both cases, the exchange rate must be adjusted.

Another regime—standard until the 1980s—that offers a compromise between the two extremes is based on fixed rates within a narrow band (which Corden described as fixed but adjustable rates). This regime features a strong exchange rate commitment, and its adherents, before the currency crises of the mid- and late 1990s, included Brazil, Mexico, and Thailand. In these emerging market countries, Corden said, where capital mobility increased steadily during the 1970s and 1980s and is now high, the authorities had difficulty maintaining a fixed peg. He noted that this regime had generally fallen out of favor, but said it was still workable for countries that had low capital mobility either because they weren't integrated with



Corden: “Countries’ options for exchange rate regimes range from floating arrangements at one extreme to firmly fixed arrangements at the other extreme.”

capital markets (like some very poor countries) or because they had effective capital controls (like China).

Corden noted that a target zone is a compromise between floating rates and fixed but adjustable rates and is a popular regime. Under it, a central rate that can be fixed, crawling, or flexible is surrounded by a band within which the central rate is permitted to float. It allows for flexibility among a country's policy objectives and works within all three of the frameworks Corden described. It is also said to prevent extreme movements in the exchange rate, an assumption with which Corden disagreed.

The three varieties of firmly fixed regimes are currency boards (where a country fixes its exchange rate to an "anchor currency"), dollarization (where a country adopts as its own the currency of a "hegemon," or dominant economy), and monetary union (where a group of well-integrated economies adopt a single currency and coordinate monetary policy). Corden listed the conditions in which such arrangements would be desirable. In general, the more open the economy, the more suitable a fixed exchange rate. Smaller countries are more likely to be open than larger ones and may thus be good candidates for a currency board arrangement. However, some small countries may be more subject to asymmetric shocks, such as changes in exchange rate regimes and, in countries lacking product diversity, a decline in the terms of trade. In such countries, the argument for a fixed exchange rate is not strong because the authorities may need more flexibility to deal with shocks.

Very small countries, Corden said, are not optimal currency areas. Such countries generally have difficulty maintaining their own currency because the rates are buffeted by external events. They should therefore peg their currency, the way small South Pacific islands might peg to the Australian dollar. Small to medium-sized countries that are better integrated with their neighbors may find that a common currency area is practical and reduces the risk of shocks.

Corden raised two issues that bear on countries' choice of exchange rate regime. The first is whether governments should have maximum freedom or be limited in their ability to conduct monetary policy. The answer, he said, depends on the country. Countries that have successfully exercised fiscal discipline should have more freedom, such as that provided under a real targets approach. Those with fiscal difficulties and a dismal macroeconomic record have no hope of maintaining a pegged rate and should not have as much room for maneuver.

The second issue has to do with the degree of openness of the economy. In general, Corden noted, the more open the economy, the less likely a nominal depreciation will lead to a real depreciation, which argues in favor of fixed exchange rates.

Country studies

Corden focused on four Latin American countries, all with histories of high inflation, saving Argentina—a "real laboratory experiment and the world's most interesting country"—for last.

Brazil. Despite a bad macroeconomic history of high inflation and changes of exchange rate regime, Brazil has still tended to maintain competitiveness and achieve high growth, Corden said. After inflation exploded in Brazil in 1992–93, the authorities instituted an exchange rate–based stabilization plan and adopted an active crawling peg, under which fiscal reform was achieved. Although the Brazilian authorities were unable to maintain fiscal discipline, and a current account deficit developed, inflation did decline. Brazil has since adopted a managed floating regime combined with inflation targeting, which gives the authorities the option of lowering interest rates to counter a severe shock (such as a decline in the terms of trade), thus avoiding recession.

Chile. In the late 1970s, Chile had a classic exchange rate–based stabilization that combined an active crawling peg with high interest rates. Although this regime successfully dampened inflation, it led to large real capital inflows. This, in turn, appreciated the real exchange rate and caused balance of payments problems, implying the need for a real depreciation. Hit by a copper price shock in the early 1980s, Chile was forced to abandon the crawling peg and has since moved to a managed floating exchange rate. According to Corden, Chile "got the fundamentals right," keeping its fiscal and monetary policies under control.

Mexico. Mexico has a long history of trying to peg its exchange rate but then being unable to sustain it and having to devalue. The depreciation of 1994–95, Corden noted, went beyond what was justified by fundamentals. The Mexican government had taken an exchange rate gamble by denominating a lot of its debt in U.S. dollars rather than in pesos. It then paid a high price when it had to devalue, because creditors were unwilling to refinance the dollar-denominated debt.

Mexico, like Brazil and Chile, now appears to have achieved success with a floating exchange rate arrangement combined with inflation targeting. However, Corden said, it may be premature to judge the three countries' experiences as successful. Although they appear to be doing well so far, he noted, the regimes are relatively untested. The real test will come when these three countries encounter major political shocks.

Argentina. Corden described Argentina as a medium-sized, closed economy that has suffered asymmetric shocks. It has a "dreadful" macroeconomic history: episodes of high or hyperinflation, endless exchange rate instability, and low growth. "Argentina is an OECD [Organization for Economic Cooperation and Development] country gone wrong"



"Mexico, like Brazil and Chile, now appears to have achieved success with a floating exchange rate arrangement combined with inflation targeting."

—Corden

Corden said; in other words, it should be a developed country but is not. By all measures, Argentina was not a good candidate for fixed rates.

However, conditions in Argentina had deteriorated to the point where the public was receptive to change, which made adoption of a currency board arrangement possible. Other prerequisites for a currency board arrangement are that the country's fiscal policy must be under control and its foreign exchange reserves must be equal to base money. Because high inflation had greatly reduced the demand for domestic money, Corden said, Argentina was able to satisfy this last criterion.

The currency board dramatically reduced inflation, he said, but wages were not sufficiently flexible and increasing wages thus led to real appreciation, which contributed to growing unemployment and encouraged protectionism. The markets lost confidence in the government's ability to repay its debts, and interest rates rose. Thus, Corden said, the authorities faced a dilemma. They would have to raise taxes to show the markets that fiscal policy was under control. If they were unsuccessful, this step could intensify the recession; but if they were successful, interest rates would fall because

people would believe the government would stop borrowing, and this could help the private sector revive and keep the economy from falling into recession.

Corden reached three conclusions. First, given Argentina's history, a currency board was probably its best option. Second, despite Argentina's success with a currency board, he would not today recommend this course of action for other countries with a similar history. Rather, he would recommend inflation targeting, which has been successful in a number of countries. Third, Corden said he would not recommend that Argentina abandon its currency board because it has acquired a certain credibility. His third conclusion runs counter to the common wisdom that the best policy for a crisis situation may not be suitable for the long term. Generally, countries are advised to have a strategy that permits them to exit the crisis policy. Corden expressed skepticism about exit strategies, because, he said, the announcement of such a strategy will immediately spark speculation, causing the exit strategy to occur ahead of schedule. His final words of advice to countries in crisis were to first let the exchange rate float and then deal with the fundamentals. ■

Leslie Alan Whittome, 1926–2001

Sir Alan Whittome, a former Counsellor of the IMF and, successively, Director of the European Department and the Exchange and Trade Relations Department, died on January 21, 2001.

Whittome was born in London in January 1926. After service with the British Army and academic studies at Cambridge University, he joined the Bank of England in 1950. He served at the Bank of England until 1964, rising to the position of Deputy Chief Cashier, with responsibility for domestic finance issues.

Whittome joined the IMF as Director of the European Department in 1964. He played a key part in negotiating Stand-By Arrangements and stabilization programs with several major European countries, including the United Kingdom in 1967, 1969, and 1977; France in 1969; and Italy in 1974 and 1977. In the 1980s, he led the IMF's efforts to develop contacts with the Eastern European countries. He was also actively involved in defining and extending the IMF's responsibilities for surveillance over the economies of its member countries.

In 1980, while retaining his position as Director of the European Department, Whittome was promoted to the rank of Counsellor. In 1987, he became Director of the Exchange and Trade Relations Department and moved to the forefront of the IMF's efforts to deal with the problems of heavily indebted countries. He retired from the IMF staff in July 1990, but accepted a one-year appointment as Special Counsellor to the Managing Director in August of that year, with responsibility for coordinating among four international organizations a study of the Soviet Union's economy that had been commissioned by the leaders of the Group of

Seven countries. In February 1995, Whittome was appointed a Special Advisor to the Managing Director to undertake a two-month study of IMF surveillance during the period leading up to the Mexican financial crisis of December 1994. He was knighted by Queen Elizabeth II in 1991.

In paying tribute to Whittome, IMF Managing Director Horst Köhler said, "Sir Alan brought an extraordinary mind and a unique style to the IMF. His mark on the IMF was enormous, and he has been missed since the day he left. He was a mentor to many IMF staff, including some of those holding senior positions today. All those whose careers and whose lives he touched will miss him dearly" (IMF News Brief 01/11, January 29).

Michel Camdessus, IMF Managing Director from 1987 to 2000, noted that "Alan Whittome was for me an incomparable mentor. On every occasion, in every step we took, Alan was always there making the decisive contribution, but he was also concerned to give credit to the hard work, imagination, or diplomatic skills of his younger colleagues. He contributed immensely to the prestige and influence of the IMF. He left, indeed, a deep imprint on the institution, but his mark was even deeper on all those who had the privilege to work closely with him. We all have learned from him something more about what international public service means."

Jacques de Larosière, who was IMF Managing Director during 1978–87, said, "I often think of Sir Alan and the wonderful years we worked together at the IMF when he headed the European Department. I remember the way he mastered the details of economic adjustment and negotiated IMF programs with competence, intelligence, and subtlety, and also with the supreme elegance and sense of humor that were his hallmark."

Sir Alan Whittome is survived by his wife and two daughters from a previous marriage.



Sir Alan Whittome

Economic globalization can directly benefit African countries' development efforts

Following are edited excerpts of an address given by IMF First Deputy Managing Director Stanley Fischer at the France-Africa Summit in Yaoundé, Cameroon, on January 19. The full text is available on the IMF's website (www.imf.org).

The past half-century has seen not only intensifying globalization but also historically spectacular growth. This relationship validates the vision of the founders of the post-World War II economic system built around the IMF, the World Bank, and what eventually became the World Trade Organization (WTO). But many of the world's poorest countries—many of them in Africa—have not seemed to benefit. Globalization seems to have passed them by.

Even so, there is no point in asking whether we should be for or against globalization. Globalization is here to stay: the reality is that we already live in a global economy—where flows of trade, capital, and knowledge across national borders are not only large but are also increasing every year. Countries unwilling to engage with other nations risk falling farther behind the rest of the world in terms of both income and human development. That way lies the very real threat of marginalization.

Rather, the right set of issues to raise is how best to take advantage of the opportunities presented by the growth and growing openness of the world economy; how best to live with the unavoidable difficulties that globalization may bring; and how to modify the system to make it operate better.

Economic policies for a globalized world

What should policymakers, especially African policymakers, do to reap the benefits of economic globalization? Let me mention two priorities. First, trade liberalization helps open economies up to competition and deepens their integration into the world economy. Some African countries have made major progress in liberalizing trade over the past several years. For example, in recent years there has been important progress in adopting a common trade policy and a relatively open customs union in CEMAC [Economic and Monetary Community of Central Africa]. Such progress could now be strengthened and extended to other parts of sub-Saharan Africa. In light of the small size of many African economies, the impulse toward regional integration is extremely important. But regional integration will help increase long-term growth only where it is truly trade increasing and not an attempt to erect new protectionist blocs.

Progress on trade liberalization in Africa should be matched by the opening of advanced country markets

to the exports of African producers. The IMF will continue to make this case vigorously whenever and wherever it can.

Second, let me talk about the importance of effective social spending. Globalization delivers its economic benefits in part by promoting change, and the rise and fall of different industries, and economic activities. The process is not a painless one.

Economists talk in the abstract about labor moving from low-productivity to high-productivity uses. But it is individuals and families who have to do the moving. If they feel threatened and unable to cope with the process of change, they will resist it, and the economic benefits will be lost.

The answer is to invest in the human capital of the poor—increasing their access to health care, education, and economic opportunity—as well as to provide a cushion during the process of adjustment, in the form of efficient social safety nets. In the past, the IMF perhaps paid too little attention to this need, but I believe we have now given it the right priority in the programs we support through our Poverty Reduction and Growth Facility (PRGF), in partnership with the World Bank.

In this rapidly changing world economy, investment in education takes on special significance. The new technologies are knowledge and skill intensive, and there is a need to train people to work with those technologies. But the training cannot be too narrow, for adaptability to change is another key to success in the modern world.

The HIV/AIDS pandemic is exacting a heavy toll in human lives. It is not only a humanitarian tragedy on an extraordinary scale but also a potentially massive economic disaster for the continent. All the more reason, then, to seek to reduce the incidence of HIV/AIDS through public health policies that have worked in several African countries.

As important as the amount of money spent is the way it is spent. This underlines the importance of good expenditure management, so that poverty-



"Globalization is here to stay: the reality is that we already live in a global economy."

—Fischer

“The international community has a responsibility to provide an external environment that will allow Africa to fulfill its potential.”

—Fischer

reduction priorities are addressed within a well-run overall budget.

There are useful lessons here for the beneficiaries of the Heavily Indebted Poor Countries (HIPC) Initiative. Twenty-two countries—18 of them in sub-Saharan Africa—are already at the point at which they are beginning to receive debt relief under the initiative. On average, it is reducing their debt-service obligations by half. It is essential that these resources be used effectively for poverty reduction, both for its own sake and also because waste will play into the hands of those who argue that aid flows are squandered and should be reduced.

Role of industrial countries

The international community has a responsibility to provide an external environment that will allow Africa to fulfill its potential. The industrial countries bear a particular responsibility in four areas:

- guaranteeing African exporters unfettered and tariff-free access to their markets, especially for agricultural products;
- supporting countries that are trying to boost growth and tackle poverty by increasing aid flows and guaranteeing them over longer periods;
- doing more to help Africa bring peace to its war-torn regions. In addition to direct efforts to resolve and prevent conflict, this means restraining arms sales and countering the smuggling of raw materials and natural resources to finance wars; and
- helping the continent fight the spread of the HIV/AIDS pandemic.

International institutions

The IMF, the World Bank, and later the WTO were set up as part of an implicit bargain: that countries that elected to play by the rules of the international system would be helped both by the basic progrowth design of the system and by loans and other assistance when in special need. That is one of the reasons why the IMF's Managing Director, Horst Köhler, reaffirmed the role of the IMF in its poorest member countries through the PRGF shortly after he took office last May. That is also why we in the IMF have been so intensively engaged in seeking to improve the ability of the IMF and the international economic system to prevent massive crises of the types seen in the last decade, and to mitigate them when they occur.

The issue of the representation of developing countries in the international institutions has been raised. With regard to the IMF, given that the Executive Board prefers to work by consensus, the quality of the representation and the number of voices, as well as the share of votes, are important. With regard to the quality of African representation,

the Executive Directors from sub-Saharan Africa are first-rate representatives of their constituencies. However, their constituencies have many members, and consideration could be given to providing each of them with extra resources to deal with the exceptionally heavy workload.

Conclusions

Promoting growth and reducing poverty are best achieved by embracing the global economy, improving policies, and strengthening institutions. This will be a difficult task, but one that can be accomplished, provided that policymakers in Africa and the international community alike are ready to do their part.

That is what the IMF believes. But some ask whether Africa is different. Pessimists claim that the continent is predestined to endure low growth, in part because it is tropical and suffers from systemic diseases such as malaria; because the quality of its soil is poor; and because many of its countries are landlocked.

We do not share this pessimism. The success of countries around the world that have managed to make serious inroads into poverty—in Asia and elsewhere—suggests that others, including African countries, can do likewise. In recent years, we have seen more and more countries adopting prudent, market-based economic policies and seeking integration into the world economy, all of which is conducive to growth and poverty reduction. Many of them have done so with advice and support from the IMF and World Bank. This strategy is beginning to show encouraging results; and we in the IMF, working closely with our colleagues in the World Bank, are committed to doing everything we can to help you strengthen and deepen these results. ■

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
January 22	4.47	4.47	5.18
January 29	4.43	4.43	5.13

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

IMF technical assistance plays crucial role in assisting countries' development efforts

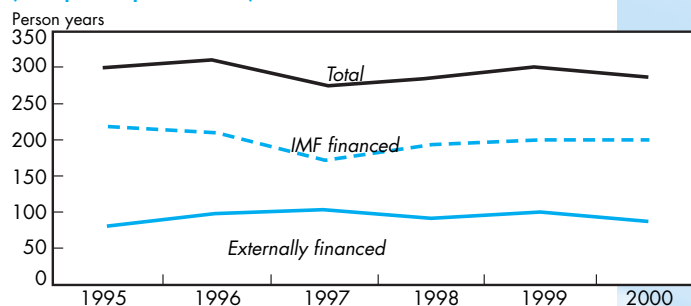
The IMF devoted some 290 person years to technical assistance work, both at IMF headquarters and in the field, during the financial year ended April 30, 2000. Three IMF departments—Fiscal Affairs, Monetary and Exchange Affairs, and Statistics—provided more than 85 percent of this assistance. At the same time, training by the IMF Institute—which provides regional and country-based courses for government officials—rose by 15 percent at IMF headquarters and 26 percent overseas.

Although the total level of resources devoted to technical assistance has remained largely constant over the past five years, there has been a gradual shift in the regional distribution from the transition economies of the former Soviet Union to Africa, which now receives about one-third of total technical assistance. As in past years, 60 percent of technical assistance was directed to members with IMF-supported programs.

External financial support for the IMF's technical assistance program has become increasingly important in the past decade. From 30 to 40 percent of total technical assistance provided by the IMF in recent years has been cofinanced by other multilateral and bilateral agencies. The single largest source of external financing is the government of Japan, which annually makes a generous grant to the Technical Assistance Framework

Total technical assistance delivered by the IMF

(headquarters plus field time)



Data: IMF.

Account and thus enables the IMF to provide about 30 percent more technical assistance to its members than would otherwise be possible. Other technical assistance partners include Switzerland, the United Kingdom, Denmark, the Netherlands, France, Australia, New Zealand, the Asian Development Bank, and the United Nations Development Program.

Technical assistance focuses on the traditional core areas of IMF expertise. In addition to the close links with program operations, recent policy measures have further formalized the links to surveillance-related work. In the past few years, there has been a steady evolution in this area, and initiatives have been launched to strengthen countries' financial systems

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and to develop financial, fiscal, and statistical standards and codes in the IMF's areas of expertise.

The objectives and scope of the technical assistance program were described in the first IMF Policy Statement on Technical Assistance, issued in March 2000 (available on the IMF's website (www.imf.org)). The direction of the IMF's technical assistance has been influenced most recently by the requirements of countries assisted under the Poverty Reduction and Growth Facility (PRGF) and the Heavily Indebted Poor Countries Initiative (HIPC), as well as by the need to support the work of the United Nations and others in postconflict situations, such as Kosovo and East Timor. Collaboration with the World Bank has increased in those areas where both institutions have an interest. These include the Financial Sector Assessment Program (FSAP), work on tracking expenditures for poverty reduction in HIPC-eligible countries, and cooperation on statistical issues through the General Data Dissemination System.

The IMF's Executive Board reviewed technical assistance in January 2001 in light of the evolving priorities of the program and related policy developments. It was recognized that the demand for technical assistance is expected to continue to expand, particularly from low-income PRGF-HIPC countries, and that follow-up technical assistance and capacity building will be needed to help countries implement the reforms arising from the recommendations contained in FSAPs and Reports on the Observance of Standards and Codes and in connection with implementing poverty reduction strategies. As a result of the Board's review, the IMF's technical assistance will be even more carefully focused than before on its core areas of competence; subject to more intensive internal scrutiny to ensure that it is appropriately prioritized; designed and implemented with the full participation of the recipient countries; and managed in much closer cooperation and coordination with other technical assistance providers. ■

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- 01/6: Second Review of Cambodia's PRGF and Approval (in principle) of \$11 Million Credit, January 19
- 01/7: IMF's Aninat Congratulates President Macapagal-Arroyo of the Philippines, January 23
- 01/8: Final Approval of Second PRGF for Central African Republic, January 23
- 01/9: \$8 Million Credit Tranche (in principle) and \$8 Million Interim Assistance Under HIPC for Mauritania, January 26
- 01/10: \$6 Million Credit Tranche for Albania, January 26
- 01/11: IMF Managing Director Köhler Issues Statement on Death of Sir Alan Whittome, January 29 (see page 46)

Public Information Notices (PINs)

- 01/2: Niger, January 12
- 01/3: IMF Reviews Experience with Publication of Staff Reports and Takes Decisions to Enhance Transparency of IMF Operations and Policies of Its Members, January 12
- 01/4: Mozambique, January 17
- 01/5: Ukraine, January 19
- 01/6: Lithuania, January 22
- 01/7: Malawi, January 23
- 01/8: Korea, February 1

Speeches

- IMF Managing Director Horst Köhler at a Press Conference, Japan National Press Club, January 12
- IMF Managing Director Horst Köhler, "New Challenges of Exchange Rate Policy," Asia-Europe Meeting of Finance Ministers, Kobe, January 13

- IMF Deputy Managing Director Eduardo Aninat, "China, Globalization, and the IMF," Foundation for Globalization Cooperation's Second Globalization Forum, Sanya City, January 14
- IMF First Deputy Managing Director Stanley Fischer, "The Challenge of Globalization in Africa," France-Africa Summit, Yaoundé, January 19 (see page 47)

Transcripts

- Press Briefing, Thomas Dawson, IMF External Relations Department Director, January 17
- [Letters of Intent and Memorandums of Economic and Financial Policies \(date posted\)](#)
- Argentina, January 12
- Georgia, January 12
- Benin, January 16
- Cambodia, January 24
- Albania, January 26
- Mauritania, January 29

[Poverty Reduction Strategy Papers \(date posted\)](#)

- Central African Republic (interim), January 16
- Georgia (interim), January 16
- Cambodia (interim), January 24

[Concluding Remarks for Article IV Consultations \(date posted\)](#)

- Ukraine, January 19
- Iceland, January 25

[Decision Point Document for Enhanced HIPC Initiative \(date posted\)](#)

- Georgia, January 17
- Niger, January 18
- Malawi, January 19
- Nicaragua, January 22

Other

- IMF Financial Activities, January 16, 22, and 29
- IMF Financial Resources and Liquidity Position, 1998–December 2000

Standards, governance, bank regulation help to integrate emerging markets in global system

What obstacles are there to the growth of emerging markets? “Round up the usual suspects,” advised Columbia University’s Frederic Mishkin at a January 11–12 Brookings-Wharton conference that focused on integrating emerging market countries in the global financial system. In response to Mishkin’s call, presenters looked at the role of property rights, bankruptcy law, standards and codes of best international practice, security market development, corporate governance, accounting standards, and bank regulation and supervision. Many also underscored how vital it is for emerging markets to be consistent in implementing the policies and the practices they choose to follow.

Environment for enterprises

A number of papers asked what steps are needed to bring the environment for enterprises in line with global standards. Reena Aggarwal from Georgetown University talked about a paradoxical situation in which emerging market economies thrive while their stock markets are in decline. She concluded that major enterprises in these emerging markets are increasingly bypassing local stock markets to list themselves on industrial country stock exchanges. But only the largest firms can do this, she said, so that the problems facing the remaining firms draw a great deal of attention.

Looking at corporate governance systems, Luis Zingales of the University of Chicago noted that the choice between a market-based “arm’s-length” approach and a relationship-based approach depends crucially on the underlying contracting system. In emerging markets, the arm’s-length model may not be optimal, he said, but it is likely to predominate in the long run, as it better accommodates international investors.

Corporate governance reform may be important, the World Bank’s Michael Pomerleano commented, but the risk of future crises will not be substantially reduced until public financial sector governance—especially that of monetary authorities—is also reformed. Governance failures in this area have played a key role in a number of recent crises, he said, citing the failure to take timely action to avoid the collapse of the Thai baht; the provision of emergency bank liquidity in Indonesia, much of which went to fund capital flight; and the hiding of foreign reserve losses prior to currency crises in Mexico and Korea.

When firms get into trouble, whether in a crisis environment or not, bankruptcy procedures become important, and potential creditors need to know what will happen. Clas Wihlborg from the University of

Gothenburg surveyed international practice and concluded that creditor-oriented systems (the traditional U.K. practice) were effective, but so were debtor-oriented systems (the French approach, for example, makes maintaining employment a principal goal). What matters is enforcement and that all parties understand what will happen in the bankruptcy proceeding.

Ray Ball of the University of Chicago discussed the closely related issue of corporate accounting, looking at how well various systems provide information on firms’ balance sheets for the purpose of monitoring and at how well they capture changes—particularly losses—in the value of the firm. He drew an important difference between common law-based systems (the United Kingdom and the United States), which are run mainly for shareholders, and those based on code law (continental Europe), in which other stakeholders have important rights. Both systems, he said, provide adequate monitoring, but both fall short, in varying degrees, in terms of capturing changes in the value of firms. Christian Leuz of the Wharton School agreed that accounting and disclosure systems are deeply embedded in a country’s institutional framework. Consequently, he observed, traditional developing country systems, in which the concerned parties are limited to reasonably well informed insiders, may in fact be the best option for an environment with weak disclosure systems.

Ball emphasized that complementary reforms are indispensable for developing better accounting systems. Legal reforms, especially those that make management liable to shareholders for misrepresenting the condition of the firm, are essential for reliable accounting systems, he said. It is a waste of resources to focus on accounting standards where the supporting infrastructure is not in place, according to Ball. As an illustration, he discussed China, which has adopted International Accounting Standards (IAS), but where company accounts remain so poor that the credibility of IAS itself is threatened.

Role of local banks

While the conference addressed a wide range of topics, many participants singled out the crucial importance



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February 5, 2001

52

of the banking sector. As Mishkin emphasized, potential banking crises are a principal source of risk in emerging markets. Weak banks make it risky for the authorities to raise interest rates, thus limiting the tools available to defend against currency crises. This in itself can trigger a crisis that brings down the banks.

Improved banking regulation and supervision are critical to maintaining a sound banking system, and the World Bank's Gerald Caprio presented new cross-country research assessing the features of supervisory systems that contribute to strong banking systems. The study concluded, most notably, that there is a strong positive link between state ownership of banks and the likelihood of a crisis. It also found a very robust link between the generosity of the deposit insurance system and bank fragility. While many of its conclusions were in line with earlier research, the comprehensive databases (see www.worldbank.org/research/interest/data.htm) that the paper draws from provide a solid foundation for future research.

View from the practitioners

Each day's discussion ended with a presentation from a speaker active in emerging markets. The first day, PIMCO Emerging Market Fund's Mohamed El-Erian challenged the image of emerging markets as risky and highly volatile. Noting that the volatility of emerging markets' security prices had declined over the past year, he pointed to a range of reasons why this was so, mentioning improved macroeconomic policies in the countries themselves, reduced participation by highly leveraged institutions, greater efforts at investor relations by borrowing countries, and a rapid response by the IMF when recent crises in Argentina and Turkey put the entire asset class at risk.

An especially positive factor in the declining volatility, he said, was the more active role played by borrowers. This greater activism ranged from conference calls with investors to increased provision of data (partly in response to IMF transparency initiatives) to greater sophistication on the part of countries' debt managers in the timing of their market activity, including absorbing some of the volatility by actively trading in their own securities.

Correction: In the January 8 issue of the *IMF Survey* the reference to the IMF's Data Quality Reference Site (DQRS) was incorrectly identified on page 12. The IMF's DQRS is available at <http://dsbb.imf.org/dqrsindex.htm>.



Frederic Mishkin



Gerald Caprio

The second day ended with a session led by IMF First Deputy Managing Director Stanley Fischer, who discussed his views on exchange rate regimes and crisis prevention. On the former, Fischer noted that the major emerging market crises of the past few years had all involved the departure from a pegged exchange rate system, while similar countries with floating rate systems had had problems without crises. He said that this had led observers to focus on the so-called corner solutions of a free float or a hard peg. Nevertheless, he added, there is room for managed floats and other intermediate solutions, especially where countries are not open to international capital flows, and he referred the audience to his recent discussion of exchange rate regimes at the meetings of the American Economic Association (see *IMF Survey*, January 22, page 26).

On crisis prevention, Fischer called attention to progress in five areas: more candid surveillance by the IMF, especially with respect to countries' vulnerabilities; introduction of the Financial Sector Assessment Program; work on developing and implementing standards and codes of good financial practice; increased transparency of the IMF itself; and introduction and reform of the IMF's Contingent Credit Lines, which he expected would soon begin to be used by member countries.

The overarching question, said Fischer, was how to minimize the damage from vulnerabilities. Once a crisis occurs, there is a necessary choice between extending guarantees to the banking system or facing the collapse of the banking system. The IMF has supported a number of countries in recent crises when they took the first course. To those who worry about moral hazard created by guarantees, he said no country would allow an unnecessarily large recession simply to serve as a warning to investors, nor should it do so. ■

Wayne Camard
IMF, External Relations Department