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STRENGTHENING THE INTERNATIONAL FINANCIAL ARCHITECTURE
Where Do We Stand?

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INTRODUCTION

It's not easy to get senior economic officials worked up about the functioning of the international monetary system. Usually, they are preoccupied with the more immediate issues surrounding the national and global economic outlook. But the Mexican peso crisis of 1994-95 and, even more so, the Asian financial crisis of 1997-98 made crisis management important for the economic outlook and pushed many of the otherwise arcane issues in the so-called "international financial architecture" (hereafter, IFA) to the front burner of economic policy.[1]

In this paper, I provide a preliminary assessment of where we now stand with respect to strengthening the IFA. Because the IFA covers such a wide subject area, it is necessary to be selective in a short paper.[2] Here, I have used the lending policies and practices of the IMF as a convenient organizing device to discuss selected key issues in the reform debate. More specifically, Section II looks at the interest rate and maturity of IMF loans. Section III focuses on the size of IMF rescue packages. Section IV, which covers the most ground, examines various dimensions of IMF conditionality, including ex post macroeconomic policy conditionality versus pre-qualification based on structural policies, the scope of IMF conditionality, the roles of currency-regime choices and private-creditor burden-sharing in conditionality, and links between Fund assistance /conditionality and implementation of international financial standards. Finally, in Section V, I offer some concluding remarks on priorities for IFA reform over the next year or two.

I have not attempted to provide a comprehensive review of the burgeoning literature on the IFA. Rather, I have selected a subset of leading reform proposals by drawing on a group of recent appraisals of the IFA, including: the Report of an Independent Task Force Sponsored by the Council on Foreign Relations (hereafter, the CFR Report [1999] and CFR Task Force); the Report of the International Financial Institution Advisory Commission (hereafter, the Meltzer Report [2000] and Meltzer Commission); the US Treasury Department Response to the IFI Advisory Commission (hereafter, US Treasury [2000]); the Report from G-7 Finance Ministers to the Heads of State and Government at Fukuoka, Japan on July 8, 2000 (hereafter, G-7 Finance Ministers [2000]); speeches on the IMF by US Treasury Secretary Summers at the London Business School in December 1999 (hereafter Summers [1999]) and before the Congress' International Monetary and Finance Committee in April 2000 (hereafter Summers [2000]); and

[1] By the IFA, I mean the institutions, policies, and practices associated with the prevention and resolution of banking, currency, and debt crises, primarily (but not exclusively) in emerging economies.

[2] For a detailed list of ongoing reform activities in the IFA, see IMF (2000a). An integrated analysis of IFA reform issues can be found in Eichengreen (1999) and Council on Foreign Relations (1999). Williamson (2000) presents analysis of reform proposols, including several made by groups not covered in this paper.

speeches on the Need for an International Lender of Last Resort and on the IMF by IMF First Deputy Managing Director Stanley Fischer in New York in January 1999 (hereafter, Fischer [1999]) and in Washington DC in February 2000 (hereafter, Fischer [2000a]).

Much of the implementation of IFA reform is being carried out with the participation of a wider group of countries than the G-7 -- be it in the Group of 20, or in the Financial Stability Forum (hereafter FSF) and its working groups, or in regional for a (e.g., ASEAN plus 3). Nevertheless, the reform proposals discussed here are relevant for gauging the broader thrust of the reform effort and perhaps also for sensing which way the "wind is blowing."

INTEREST RATES AND MATURITY OF IMF LOANS

Part of Bagehot's (1873) famous counsel for an official lender of last resort is that it should lend at a penalty rate. If the interest rate is too low, borrowers that are in trouble may not face a sufficient incentive to be more careful next time; they will also see the official lender as their first, not last resort. In addition, borrowers that are not currently in trouble may take excessive risks because they know that there is a cheap source of credit available if things turn out badly.

With these considerations in mind, it has often been suggested that the Fund increase the interest rate it charges borrowers. Countries that enter into standby and Extended Financing Facility (EFF) arrangements with the Fund pay an interest rate (called the rate of charge) that is a weighted average of short-term interest rates in the G-5 countries (United States, France, Germany, Japan, and the United Kingdom) plus a small surcharge. The rate of charge averaged 4.7 percent in 1997, 4.4 percent in 1998, 3.9 percent in 1999, and 4.8 percent in the first half of this year. Developing countries, particularly when they are encountering difficulties and/or crisis conditions, have to pay much more than that to access private international capital markets. For example, emerging-market bond spreads (relative to US Treasuries) have fluctuated from 375 to 1700 basis points since the outbreak of the Thai crisis in mid-1997. This large difference between Fund and private borrowing costs is characterized by some as an unwarranted subsidy that promotes both excessive borrowing from the Fund and borrower "moral hazard."

In late 1997, the Fund seemingly took some account of this criticism by endowing its newly created Supplemental Reserve Facility (SRF) with an interest rate of 300-500 basis points above the rate of charge on regular IMF loans (with the rate higher for longer repayments than for shorter ones). Judging from the recent G-7 Finance Ministers Report (2000), a move to impose a similar pricing structure on all IMF non-concessional lending windows could be in the offing (so as to "... encourage access to private capital and discourage prolonged use [of IMF resources]..."

US Treasury Secretary Summers (2000) concluded in April of this year that "...a strong case could be made for an overall increase in the basic rate of charge" (p. 5).

The Meltzer Commission (2000) concluded that IMF interest rates (presumingly, including SRF rates) are not high enough; specifically, they propose that Fund borrowing cost be set at a premium over the sovereign yield paid by the borrowing country one week prior to applying for an IMF loan. The US Treasury (2000) concluded that such a (Meltzer Commission) penalty rate would be too high -- so high as to worsen the underlying financial position of the borrowing country. The Fund's First Deputy Managing Director, Stanley Fischer (1999), has also argued that the penalty rate charged by the lender of last resort should be defined relative to the interest rate during "normal" times (not one week prior to the crisis), since the objective of the rescue is to achieve the good -- non-panic -- equilibrium. This would imply penalty rates closer to SRF terms than to "Meltzer" terms.

I suspect that if SRF interest rate terms were extended to all non-concessional IMF lending, the impact would be greater on the speed with which countries repay their Fund borrowings than on the frequency of Fund borrowing. I say that for two reasons.

First, when countries finally decide to ask the Fund for emergency financial assistance, it is usually in dire circumstances when financing from the private capital markets is unavailable in large amounts. As argued by Eichengreen (2000), politicians who are fighting for survival are not likely to be deterred from "gambling for resurrection" by a higher interest rate. As such, the decision to go to the Fund is apt to be less price elastic than the decision of how rapidly to repay the Fund loan (since the crisis country should have more room for maneuver at the time of repayment).

Second, we should not forget that a big difference between (upper credit tranche) IMF programs and loans from the private sector is that the former come with strong policy conditionality. Whatever its economic merits, such policy conditionality may be viewed as politically costly by the borrowing country since domestic political opponents can argue that the authorities have surrendered the steering wheel to "foreigners." In other words, when comparing IMF loans to private-sector loans, we have to look at the "conditionality-equivalent" interest rate, not just the nominal interest rate. A strong hint that conditionality matters for perceived borrowing cost is that, despite the large difference in nominal borrowing costs as between the Fund and private markets, we don't observe emerging economies tripping over themselves in a rush to come to the IMF at the first sign of balance-of-payments trouble. Instead, as argued above, countries come to the Fund late in the game. Conditionality (along with the Fund's senior creditor status) also gives Fund loans a higher probability of repayment than loans made by

private creditors, implying that the market-clearing nominal interest rate for Fund loans is lower than that for private-sector ones. All of this in turn suggests that an increase in the rate of charge may not have a huge impact on the frequency of Fund borrowing.

Next, consider the maturity of IMF loans. Standby arrangements cover a 1- to 3-year period, drawings are phased on a quarterly basis, and repayments are made within 3.25 to 5 years of each drawing. EFF arrangements, which are meant to address adjustment problems which require bold structural transformation of the economy, normally run for 3 years (and can be extended for a fourth), have phasing comparable to standby arrangements, and repayments are made within 4.5 to 10 years of the drawing. Since the SRF was meant to deal with "... exceptional balance of payments difficulties due to a large, short-term financing need resulting from the sudden disruptive loss of market confidence ...," it was created with shorter than normal repayment terms, namely 1 to 1.5 years after each disbursement.

The Meltzer Commission (2000) has proposed that the maturity of IMF loans be cut back more drastically -- to a maximum of 120 days with only one allowable rollover (leading to a maximum maturity of 240 days). The underlying rationale is that the Fund ought to be lending solely to counter liquidity crisis (not insolvency crises) and that liquidity crises are typically very short-lived. The Meltzer Commission notes that prolonged use of IMF resources has been a serious shortcoming of IMF lending, with 24 of the Fund's member countries in debt to the Fund in 30 or more of the past 50 years, and 46 more countries in debt for at least 20 of those years.

The US Treasury (2000) has called the Meltzer repayment period "unrealistically short," noting that even in recent success cases, countries needed much longer than 4 months to be in a position to repay IMF loans. Fischer (1999) has rejected the notion that is straightforward to distinguish cases of illiquidity from insolvency. He argues that this distinction is often indeterminate in a crisis since it depends on how well the crisis is managed.

The G-7 Finance Ministers (2000), along with US Treasury Secretary Summers (2000), have acknowledged that prolonged use of Fund resources needs to be more strongly discouraged, albeit without suggesting a specific maturity cap. Instead, they would rely on an SRF-like price incentive to encourage prompt repayment. The G-7 Finance Ministers Report (2000) argues that for all non-concessional IMF facilities, "... the interest rate should increase on a graduated basis the longer countries have IMF resources outstanding." Presumably, they are aiming for something closer to SRF maturities (1-2 years) than to Meltzer maturities (4-8 months). In addition, there is a definite suggestion to make more selective and less frequent resort to the longer-maturity EFF window (in favor of shorter-maturity standby arrangements). Summers (2000) argues that the countries that are likely to fit the EFF's (new) requirements are lower-

income transition countries that are undertaking far-reaching structural reforms to secure stabilization, and countries with incomes just above the threshold for concessional IMF financing under the Poverty Reduction and Growth Facility (PRGF).

Given the contrast between the Fund's stated purpose (Article I of the Fund's Articles of Agreement speaks of making the Fund's general resources "temporarily available" to members dealing with balance of payments problems) and the track record of frequent prolonged use of Fund resources, moving to reduce the maturity and repayment periods for IMF loans makes sense. Charging higher interest rates for longer repayment periods should help to promote that objective. Likewise, making resort to the EFF less frequent should keep the Fund from getting too involved in those longer-term structural aspects of development that are best handled by the World Bank (see discussion in Section IV on the scope of Fund conditionality). It seems neither necessary nor desirable, however, to insist on repayment within a few months' time a la the Meltzer Commission recommendations. The recoveries from both the Asian crisis and the Mexican crisis have been rapid -- indeed, much quicker than is normally the case for countries experiencing "twin crises" (i.e., the simultaneous occurrence of currency and banking crises).[3] Policy should not be set solely in terms of the best performers. Moreover, in many cases, the relatively rapid resumption of market access was accelerated by large-scale bail-outs and guarantees for large, uninsured creditors of banks -- bail-outs that we should seek to avoid or reduce in the future. And in cases where the illiquidity/insolvency distinction is more blurred (e.g., in the debt crisis of the 1980s), it will be helpful to have longer than 8 months for countries to repay.

It is also relevant to contrast the current mood on repayment maturities with that prevailing at the time the longer-maturity Fund lending windows (the EFF, the Structural Adjustment Facility, and the Enhanced Structural Adjustment Facility) were created. At that time, the maturity of Fund loans was also under attack -- but from the opposite direction.[4] Then, the criticism was that Fund lending programs were too short-sighted, too focused on correcting balance-of-payments disequilibria, and not focused enough at promoting sustainable economic growth. Demand-management alone could not do the job; supply measures were needed and these would take time. The recommended prescription was greater financial support for structural reforms, along with longer program periods and repayment maturities to allow those structural reforms to take hold and bear fruit. Now that many more developing countries have access to private capital markets, that private capital flows have become extremely large relative to official

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[3] See Goldstein et al. (2000).
[4] See, for example, Helleiner (1987), Camdessus (1987), and Conable (1987).

finance, and that prolonged use of Fund resources has become a widespread problem, the pendulum is swinging back the other way.

SIZE OF FUND LOANS

Another important dimension of Fund lending is the size of rescue packages. The Fund's normal access limits for its loans are expressed in terms of a country's quota in the Fund. More specifically, the normal access limits are 100 percent of quota annually and 300 percent on a cumulative basis. By this metric, the amounts committed under rescue packages for Mexico (1995), Thailand (1997), Indonesia (1997), and Brazil (1998) were exceptionally large since they fell in range of 500-700 percent of quota. The rescue package for South Korea (1997) was much larger still --1900 percent of quota.[5]

The amounts actually disbursed under the Asian rescue packages were however considerably smaller than the amounts committed. More fundamentally, the IMF has maintained that other metrics should be used to evaluate the size of packages instead of quotas (or absolute dollar figures). Fischer (1999) and Mussa (1999) have noted that Fund quotas have not kept pace with the growth of GDP, trade, or capital mobility, and therefore that quotas constitute a poor benchmark for evaluating the size of Fund loans. Fischer (1999) notes that if the IMF quotas were today the same size relative to output of IMF member countries as they were in 1945, quotas would be three times larger; adjusting quotas for the growth of world trade over the same period would leave them nine times larger. In a related vein, Mussa (1999) contends that official financing in the Asian crisis was not large relative to the decline in gross private capital flows during that period, or to the crisis countries' current-account adjustments, or to the huge output losses borne by the crisis countries.

Much of the recent concern about the size of Fund emergency financing has been that large rescue packages may contribute to moral hazard on the part of private creditors to emerging economies. If these private creditors come to expect that Fund loans to emerging-economy governments will make these governments more capable and more likely to bail them out in cases of adverse circumstances, then private creditors will act less prudently in monitoring the performance of borrowers. Put in other words, if private creditors are shielded unduly from the consequences of poor lending and investment decisions, market discipline will suffer and future crises will become more likely.

[5] One of the reasons the rescue package for Korea was so large relative to its quota is that Korea's quota is so small for its economic size.

Most analysts that call for smaller IMF rescue packages on grounds of lender moral hazard acknowledge that moral hazard is a problem with all insurance arrangements. The solution is not to have no insurance but rather to limit the amount of payment (e.g., coinsurance or deductibles) and/or to price the insurance appropriately (i.e., higher insurance rates for more risky policyholders). They also concede that a lender of last resort, by providing emergency assistance to an illiquid (but not insolvent) borrower and thereby preventing a costly default and its spillover to other borrowers, serves a useful function for the economy as a whole. Moreover, it is recognized that equity holders and bond holders suffered large losses in the Asian crisis, and that banks took a sizeable hit during the Russian crisis. Still, most of the critics conclude that smaller IMF rescue packages would reduce lender moral hazard and improve market discipline and crisis prevention.

On the other side of the fence, even those who regard the (lender) moral hazard criticism as greatly exaggerated acknowledge that Fund rescue packages in the run-up to the Russian crisis of 1998 were too large and were a key reason why investors continued to pour money into Russian government securities (GKOs) despite weak economic fundamentals. They argue however that there is no empirical evidence suggesting that moral hazard was driving private capital flows to Mexico and or to Asia in the run-up to their crises, or that the composition of capital flows has since then switched in favor of the lenders (banks) usually singled-out as the main beneficiaries of lender moral hazard. [6] On conceptual grounds, they also emphasize that since Fund rescue packages are loans (not grants) with reasonable interest rates and with a history of very low default; since there are no losses on these loans, Fund lending cannot be considered a "direct" source of moral hazard.[7] Moreover, they maintain that moral hazard is small relative to the real hazards facing developing countries in today's capital markets.

Although the Meltzer Report (2000) concludes that Fund loans generate serious moral hazard problems ("the importance of the moral hazard problem cannot be overstated," 33), the Commission does not recommend smaller IMF rescue packages as an antidote for that problem. Following the Bagehot (1873) guideline that a lender of last resort should "lend freely" (albeit at a penalty rate and on good collateral), they propose that the Fund lend on a substantial scale -- indeed, up to one year's tax revenue --to countries that have met certain pre-qualification criteria. This could result in massive rescue packages -- far larger than any loans the Fund has extended

[6] See Zhang (1999) and Eichengreen and Hausman (2000).
[7] See Mussa (1999). He refers to "indirect" moral hazard as a situation where international financial support facilitates moral hazard by national governments. The Meltzer Report [2000] has this in mind when it charges that the IMF "... did little (in Asia) to end the use of the banking and financial systems to

heretofore. For example, as noted by the US Treasury (2000), such a lending guideline, if say, applied to Brazil in 1997 would have resulted in a $139 billion rescue package -- 3088 percent of Brazil's quota in the Fund and almost ten times as large as the Fund rescue package extended to Brazil in early 1999. The Meltzer Commission proposes instead that moral hazard problems be tackled by encouraging financial institutions in the borrowing countries to adopt higher standards of safety and soundness and by discouraging reliance on short-term borrowing.

The strongest call for a return to smaller Fund loans has come from the CFR Task Force. The CFR Report (1999) argues that the Fund should distinguish "country crises" (crises that do not threaten the functioning of the international financial system) from "systemic crises," and should treat the two differently. For country crises, the Fund should return to normal access limits (100-300 percent of quota). For systemic crises, the Fund should turn to systemic lending windows -- the existing New Arrangement to Borrow (NAB) if the crisis is mainly the result of the borrowing country's policy inadequacies and a Fund program is needed to correct those policy shortcomings, and a newly created "contagion facility" if the country is mainly a victim of contagion. A super-majority of creditor countries would have to reach the judgement that the crisis was "systemic" to activate either the NAB or the contagion facility. Once activated however, the systemic facilities could provide large access and the contagion facility would be funded by a special allocation of IMF Special Drawing Rights (SDRs).

The CFR Report (1999) maintains that smaller Fund loans for country crises would still permit some cushioning of the recession, some smoothing operations in foreign exchange markets, and a modest contribution toward the cost of bank restructuring and recapitalization. These loans would not however -- desirably in the report's view -- be large enough to support the defense of overvalued fixed exchange rates or to bail-out large uninsured private creditors. The CFR Task Force also rejects the view that there is certain unique size of a Fund rescue package that is needed to restore "confidence" in the crisis country. It notes that some empirical studies have found that asset prices typically fail to stabilize right after the signing of a Fund program;[8] instead, stability comes later, when there is stronger evidence of political leadership and when there are concrete policy actions to deal with policy shortcomings. Yes, the CFR Task Force acknowledges that smaller Fund rescue packages would probably increase the cost of market borrowing for developing countries and perhaps reduce somewhat the flow of private capital to them. But it argues that since net private capital flows to emerging economies in 1990-96 period

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finance government-favored projects, eliminate so-called "crony capitalism" and corruption, or promote safer and sounder banking and financial systems." (p. 33).

[8] See Brealey and Kaplanis (1999).

were too large and the interest rate spread on that borrowing too low, some moderate move in the opposite direction would be no bad thing.

By going to smaller Fund loans for country crises, by making IMF loans to countries with unsustainable debt profiles conditional on greater private-creditor burden sharing, and by encouraging all countries to include "collective action clauses" in their sovereign bond contracts, the CFR Report (1999) believes it would be possible to reduce significantly indirect (lender) moral hazard stemming from Fund rescue packages. [9]

The US Treasury (2000) has rejected the very large Fund loans implicit in the Meltzer Commission recommendations as "... unrealistic and undesirable" and as surpassing the financial capacity of the Fund and increasing moral hazard.

It is only relatively recently that the US Treasury and G-7 Finance Ministers have come out in favor of some incentives or mechanisms to reduce the scale of IMF loans. In his April 2000 speech, Secretary Summers proposes that the interest rate on all non-concessional IMF loans should not only increase with the length of time loans are outstanding but should also increase with the scale of financing above certain thresholds (he doesn't specify what these thresholds should be). Even more recently, the G-7 Finance Ministers' Report [2000] states that "... the possibility of adding a premium when the scale of [Fund] financing goes beyond certain thresholds should be explored."

There appear to be three main differences between the CFR view and the US Treasury view on the scale of Fund financing.

First, as regards constraints/disincentives on large rescue packages, the Treasury prefers a price (interest rate) mechanism while the CFR Task Force prefers a quantity cum governance constraint (i.e., loans above 300 percent of quota would have to be deemed "systemic" by a super-majority of creditors, and those official creditors -- not the Fund -- would bear the credit risk). A disadvantage of the interest rate approach (and of leaving the decision to be made by the borrower) is that countries in crisis may be willing to pay a large premium to get enough Fund resources to defend overvalued exchange rates or to bail-out uninsured private creditors -- even if there is no a systemic risk involved. If such a demand for large rescue packages is relatively price-inelastic, then lender moral hazard will not be much deterred by such a (moderate) size-related premium. The disadvantage of the quantity cum governance approach is the risk of inaction in the face of a genuine systemic threat, i.e., a super-majority of official creditors may allow the crisis to spread by refusing to extend the larger loan.

[9] On the importance of collection action clauses and creditor steering committees, see Eichengreen (1999).

A second difference is that the Treasury's approach gives more "discretion" to IMF management and to US authorities in deciding when to activate very large rescue packages. This is because the definition of "exceptional circumstances" which activates abnormally large access under standby and EFF arrangements, and the definition of "systemic" which activates very large access under the SRF and CCL, are in the eye of the beholder and don't require super-majority consent. In contrast, the CFR approach makes the decision to activate very large access one is that is shared more equally among a wider group of creditor countries.

Yet a third difference relates to the financing of very large rescue packages. Under existing Fund policy, the large access afforded under the SRF and CCL are financed out of the Fund's existing quota pool of resources. This runs the risk that if there are many serious financial crises occurring simultaneously and if it has been some time since the Fund has had a quota increase (as in 1998), then the Fund may not have enough resources to put out such a large and contagious fire. In contrast, the CFR approach provides new money for systemic contagion cases by financing large access with a special SDR allocation.

Like the US Treasury and the IMF, I regard the potentially huge access levels recommended by the Meltzer Report as unrealistic and counter-productive (especially given their shunning of ex post macro policy conditionality; see discussion below). Also, and not surprisingly (given my role as project director and author of the CFR Report), I regard the CFR approach to discouraging large rescues as preferable to the interest-rate-premium approach proposed recently by the US Treasury. That being said, I welcome the readiness on the part of the Treasury -- and hopefully the G-7 as well -- to explore ways of returning to smaller IMF rescues. In my view, this is crucial to getting a better handle on (indirect) lender moral hazard on the part of the IMF.

IMF POLICY CONDITIONALITY

Returning once again to the Bagehot (1873) guideline for a (national) lender of last resort, it specifies that lending should be done on "good collateral." In this context, good collateral serves several purposes. It provides a test of whether the borrower is just illiquid rather than insolvent (i.e., a solvent borrower has good collateral to pledge; an insolvent one does not). Because the good collateral has market value, it safeguards the solvency of the lender. It also avoids the potentially time-consuming process of negotiating and monitoring conditions on the borrower that would maximize the likelihood of repayment. And it reduces (borrower) moral hazard by discouraging the borrower from holding risky assets that would not be accepted as good collateral.

The IMF does not lend to countries against collateral. Instead, it lends to countries that have a balance of payment need under "adequate safeguards." What are these safeguards? The main one is the policy action(s) -- so-called "conditionality" -- that the borrowing country agrees to undertake to qualify for the loans. These policy conditions are meant to correct the underlying balance-of-payments problem and to restore the borrower's ability to repay the Fund. Policy conditions are negotiated and agreed between the borrowing country and the Fund. These conditions typically cover macroeconomic policies (i.e., monetary and fiscal policies), exchange rate policy, and a range of structural policies (e.g., financial-sector policies, trade policy, reform of public enterprises, etc). As a further safeguard, Fund disbursements are made in phases or "tranches" (rather than all at once), with the ability to draw that tranche dependent on the borrower meeting certain pre-agreed performance criteria.[10] Because some other lenders (both official and private) condition their lending to the borrowing country on either the existence and/or successful implementation of a Fund program, the amount of funding that the borrowing country can lose by not meeting the performance criteria is usually larger than the loss of Fund support. If the borrower does not repay the Fund on time, it faces loss of access to future Fund lending and ultimately even expulsion. And since member countries regard their creditor position in the Fund as part of their international reserves, the Fund has consistently maintained the view that it cannot reschedule its loans to countries with debt-servicing difficulties. Some observers submit that the explicit and implicit costs that would be associated with not repaying Fund loans give the Fund a de facto if not de jure status as a preferred (senior) creditor.

Even the most ardent supporters of the Fund would admit that the above description of Fund conditionality does not do justice to the problems often encountered in its implementation. In some cases, negotiations over policy conditions can be long and contentious, and the borrowing country may never take "ownership" of the program. Drawings may be interrupted because of non-observance of the performance criteria. Sometimes, funding may continue despite non-observance of performance criteria because of political pressures from a variety of sources (including the Fund's major shareholder countries). In still other cases, the economic analysis and advice embodied in the policy conditions may be inappropriate for the unfolding economic conditions on the ground (e.g., the recession may be deeper than anticipated when the program was formulated) and revisions to program design may be too slow in coming. And borrowing countries that do not repay on time may either get de facto rescheduling (extension of new IMF

[10] These performance criteria are meant to be within the control of the borrower. If unexpected developments intrude that prevent the borrower from meeting the performance criteria, the borrower may be granted a "waiver" to draw anyway.

loans to repay earlier ones) or may get many chances to repay before their eligibility for new loans is cut off or before they get expelled. Still, when all is said and done, supporters argue that the existing system of conditionality works reasonably well most of the time, and that, just as importantly, it works better than the leading alternatives.

Much of the recent debate about the need for IMF reform revolves around various dimensions of policy conditionality. Here, we take up in turn four such dimensions, namely: (i) ex post policy conditionality versus ex ante conditionality (i.e., pre-qualification based on structural-policy pre-conditions); (ii) the scope of conditionality; (iii) currency regime and private-sector burden-sharing aspects of conditionality; and (iv) implementation of international financial standards.[11]

(i) ex post policy conditionality versus pre-conditions (i.e., ex ante conditionality) --The Meltzer Report (2000) was extremely critical of the existing (ex post) approach to Fund conditionality. The majority in the Meltzer Commission concluded (2000, p.7) that detailed Fund policy conditionality has "... burdened IMF programs in recent years and made such programs unwieldy, highly conflictive, time consuming to negotitate, and often ineffectual." They go on to argue that there is no evidence of systematic, predictable effects from most of the IMF's policy conditionality. Later on, they maintain (not entirely consistently) both that if the IMF did not exist, the market would force a country in crisis to follow similar policies and that IMF policy conditionality in the Asian crisis actually made the crisis countries worse off than they would have been without IMF assistance. Put in other words, when the bottom-line results in IMF program countries look good, the outcome would have happened anyway (without the IMF); and when the results look bad, they reflect the negative influence of IMF policy conditionality and advice.

Interestingly enough, the Meltzer Report (2000) did not recommend that the Fund insist on "good collateral" as a substitute for its policy conditionality (despite the fact that the Commission's Chairman favored this prescription in his recent writings on how to redesign the Fund[12]). Some have argued that if countries in crises were able to satisfy a stringent collateral requirement, then they wouldn't need the Fund (i.e., they would be able to use this collateral to borrow from private creditors); hence, little "additional" financial stability would be obtained by such a reform. While one can point to episodes where even borrowers with good collateral could

[11] There is also an issue of whether Fund conditionality should supercede any conditionality that would be linked to crisis lending from "regional" official crisis lenders (such as an Asian Monetary Fund). I have not taken up this issue here because it is expected to be discussed in other papers prepared for this conference.
[12] See, for example, Meltzer (1999).

not get credit in a panic, perhaps the Commission gave this “additionality” argument some weight. Or perhaps the Commission became convinced that giving the Fund a more established de jure status as a preferred creditor -- and lending only to countries that met certain pre-qualification requirements (see discussion below) -- would provide sufficient protection for the Fund against credit risk. Or perhaps the collateral idea just wasn’t deemed attractive enough to elicit majority support either within the Commission or outside more generally. In any case, the collateral idea (as a substitute for ex post policy conditionality) went by the wayside.

Nevertheless, the Meltzer Report (2000) did recommend that the Fund eliminate most of the macroeconomic and structural policy conditions that have characterized (upper credit tranche) Fund programs in the past. It proposed instead that countries qualifying for short-term Fund liquidity assistance would need to meet the following pre-conditions: (a) freedom of entry and operation for foreign financial institutions; (b) regular and timely publication of the maturity structure of outstanding sovereign and guaranteed debt and off-balance sheet liabilities; (c) adequate capitalization of commercial banks -- either by a significant equity position a la international standards, or by subordinated debt held by non-governmental and unaffiliated entities; and (d) a proper fiscal requirement. These new rules would be phased in over a period of five years.

Developing countries that met these pre-conditions would be eligible immediately for short-term liquidity assistance; those developing countries that didn’t meet these pre-conditions would not be eligible (unless there is an unusual situation where the "... crisis poses a threat to the global economy”). Larger industrial countries would not be eligible for IMF liquidity assistance; their central banks would assume this task.

To establish the seniority of IMF claims on borrowing countries, members would exempt the IMF from negative pledge clauses and would give the IMF specific legal priority with respect to all other creditors (secured and unsecured). Countries that defaulted on IMF debts would not be eligible for loans or grants from other multilateral agencies or other member countries.

Under the Meltzer Commission plan, the IMF would continue to offer advice on a wider range of economic policies (including the currency regime) in its Article IV consultations with developing countries, and these reports would be published promptly. Industrial countries could opt out of these IMF consultations if they wished. But the IMF could not make its advice on economic policy a condition for its loans. Nor could the IMF make other types of loans for whatever purpose. Longer-term institutional assistance to foster economic development would be the responsibility of a reconstructed World Bank or regional development banks. The IMF’s Poverty Reduction and Growth Facility (PGRF) would be closed.

Criticisms of the structural policy pre-conditions in the Meltzer Report have been offered mainly on four grounds.

First, there is the charge that the (majority in the) Meltzer Commission misread history. This criticism is evident within the Meltzer Commission itself from the dissent penned by four of the commission members appointed by the Congressional Democrats (namely, C. Fred Bergsten, Richard Huber, Jerome Levinson, and Esteban Torres).[13] In looking at the 50-year tenure of the IMF and the World Bank (hereafter, the IFIs), the dissenters concluded that "... the bottom-line of the "era of the IFIs." despite obvious shortcomings, has been an unambiguous success of historic proportions in both economic and social terms." (p. 119). They note, in addition that almost all the crisis countries of the past few years, ranging from Mexico to East Asia to Brazil, have experienced rapid "V-shaped" recoveries; that never in human history have so many people advanced so rapidly out of abject poverty; and that more than half of the world's population now lives under democratic governments. In short, "... the allegations of the report simply fail to square with history." (p. 121).

The CFR Report (1999), while stressing the need for IMF reform, painted a more favorable picture of IMF involvement. For example, in evaluating the Fund's role during the Asian crisis, the Report concluded: "...As costly as the Asian crisis has been, no doubt we would have seen even deeper recessions, more competitive devaluations, more defaults, and more resort to trade restrictions if no financial support had been provided by the IMF to the crisis countries.... there can be legitimate differences of view about IMF advice on fiscal and monetary policy in the crisis countries.... But we had a look in the 1930s at how serious global instability is handled without an IMF, and few would want to return to that world." (p. 88).

The IMF has challenged the Meltzer Report's reading of the empirical studies on the effects of IMF programs. Fischer (2000), for example, sums up the recent studies as follows: "The consensus view now seems to be that in a typical [IMF] program, economic activity will be depressed in the short term as macroeconomic policies are tightened, but that growth subsequently revives as structural reforms take root. Meanwhile, the balance of payments improves, removing the need for further Fund financing. The impact on inflation is usually favorable (although in general not large enough to be statistically significant" (p. 8).

[13] The Meltzer Commission had 11 members. Six of those (Allan Meltzer, Chairman; Charles Calomiris, Tom Campbell, Edwin Feulner, Lee Hoskins, and Manuel Johnson) were appointed by the Congressional Repurblicans; the other five members (Fred Bergsten, Richard Huber, Jerome Levinson, Jeffrey Sachs, and Esteban Torres) were appointed by the Congressional Democrats. In the end, eight members (all six Repubican appointees, Jeff Sachs, and Richard Huber) voted for the Report, and four members were opposed (including Richard Huber who supported both the majority and minority reports).

A second line of criticism of the Meltzer pre-conditions approach is that these pre-conditions would not suffice either to prevent financial crises or to achieve the balance -of-payments adjustment necessary to restore countries' ability to repay the Fund; some critics would go farther and argue that reliance on these pre-conditions alone would promote financial instability.

Again, the dissenting group within the Meltzer Commission reached very different conclusions than the majority. Specifically, they argued that majority would have the IMF totally ignore the macroeconomic policy stance of the crisis country, thereby sanctioning Fund support for countries with runaway budget deficits and profligate monetary policies. They go on to conclude that: "... this would virtually eliminate any prospect of overcoming the crisis; it would instead enable the country to perpetuate the very policies that triggered the crisis in the first place and thus greatly increase the risk of global instability." (p. 121). They also note that the "proper fiscal requirement" included in the pre-conditions is left undefined in the Report, and if left open to content, would require Fund conditionality of the same type that the majority rejects.[14]

The US Treasury (2000) reached a similar verdict on the effectiveness of the proposed Meltzer pre-conditions: "... the proposed eligibility criteria are too narrow. Even where they are met, they would be unlikely to protect economies from the broad range of potential causes of crises. The criteria focus on the financial sector, and yet even problems that surface in the financial sector often have their roots in deeper economic and structural weaknesses." (p. 17). The Treasury worries further that combining large Fund disbursements with ineffective eligibility requirements could actually increase the amount of moral hazard in the system.

Yet a third criticism is that it would prove neither feasible nor desirable to exclude completely from IMF financing countries that didn't meet the structural pre-conditions. Fischer (1999) offers the following assessment on that point: "... It is doubtful that the international community would be indifferent to the fate of countries that do not meet the pre-qualification requirements, or to the instability that might be generated when they get into trouble and are denied help. In practice, in such circumstances the large industrial countries would probably find another, less transparent, way to help the country in crisis." (p. 10). I suppose the retort of the Meltzer Commission would be that other ways of assisting countries that don't meet the pre-

[14] My IIE colleague, C. Fred Bergsten, who was a member of both the Meltzer Commission and the CFR Task Force, maintains that both the undefined "proper fiscal requirement" and the systemic override (that allows assistance to countries that don't meet the pre-qualification criteria if there is a threat to the global economy) were added to the Meltzer Report at the last minute in an attempt to reduce the impact of the joint dissent.

qualification requirement are to be preferred to IMF assistance since they would be more (not less) transparent and wouldn't risk turning the IMF into a "political slush fund."

The CFR report (1999) rejected the all-or-nothing approach to eligibility for IMF assistance. In its recommendations, countries that follow a set of "good housekeeping" crisis-prevention policies qualify for a lower interest rate from the Fund than do countries that do not follow these policies. But the latter group is not excluded from IMF assistance.

In its evaluation of the Meltzer Commission's pre-qualification criteria, the US Treasury (2000) argued: "... this recommendation would preclude the IMF from being able to respond to financial emergencies and support recovery in the vast majority of its members, possibly including all of the emerging market countries affected by the financial crises of 1997 and 1998.[15] The exclusive focus on relatively strong emerging economies would leave out most of the Fund's membership, notably all low income countries and many transition economies." (p. 17).

The fourth set of criticisms of the Meltzer pre-conditions is that their implementation would involve more serious operational problems and raise more questions than the authors imply. For one thing, as argued in the CFR Report (1999), it is far from clear that pre-qualification would deter speculative attacks. Hong Kong, for example, had $60 billion-$100 billion of reserves in 1997-98 and pledges of financial support from Beijing; yet it faced strong attacks on its currency during that period. For another, it is probably naive to assume that the decision to declare countries that originally met the pre-conditions as ineligible (because of subsequent backtracking on compliance) would not be subject to strong political pressures. Also, the Report does not discuss who would monitor compliance with the pre-conditions; if the answer is that national regulatory authorities would do it (see discussion below on international financial standards), then there is a serious question of whether those judgements would be objective. Last but not least, there are questions about whether some of the pre-conditions would have their intended effects. For example, Garber (2000) has argued that a subordinated debt requirement for banks (similar to the proposal advanced by the Meltzer Commission) could likely be manipulated and evaded, thereby weakening its attraction as a mechanism for stronger market discipline.

At present, the notion of pre-qualifying for IMF liquidity assistance applies only to drawings under the Fund's recently-established (April 1999) Contingency Credit Line (CCL). Countries can qualify for the CCL if they have good macro policies, are complying with international financial standards, and have constructive relations with their private creditors. As originally formulated, eligibility to draw was far from automatic; however, specifically, pre-

[15] Bergsten (2000) made essentially the same point in earlier testimony on the Meltzer Report before the Senate Committee on Banking, Housing, and Urban Affars.

qualified countries could not draw until the IMF's Executive Board conducted an activation review to determine if the country was severely affected by contagion and if it intended to adjust its policies as needed. In addition, countries were to pay a commitment fee and an interest rate that was the same as under the SRF. So far, all of this has been academic as (somewhat embarrassingly) no country has yet applied for the CCL. According to the IMF (Fischer [2000]), the unpopularity of the CCL probably owes to its pricing structure: because the interest rate on the CCL is the same as that on the SRF, there is no incentive to pre-qualify; in addition, access to the credit line is not automatic enough once the crisis breaks out. An alternative hypothesis is that the unpopularity derives from the ambiguous signal that applying for the CCL sends, i.e., it could be interpreted as suggesting the country is expecting trouble; in addition, because the IMF has recently speeded up its decision making for disbursement from other Fund facilities in a crisis, pre-qualification may not confer as much of an advantage as previously supposed. In any case, the G-7 Finance Ministers (2000) have suggested that the CCL be made more attractive: the commitment fee should be abolished, the interest rate on it should be reduced below that on the SRF, and the initial drawing on the CCL should be made more automatic (up to a certain predetermined limit). We'll see if that sweetener attracts any more bees.

In the end, I do not find the Meltzer structural-policy pre-conditions attractive as an alternative way of qualifying countries for IMF financial assistance. While I think that meeting those criteria would, ceteris paribus, reduce the risk of getting into a crisis, they're not sufficient by themselves to deter a crisis; just as important, they are not very useful for getting out of a crisis once it hits. While many financial crises begin in the banking sector, more than a few others do not, and freedom of entry in banking plus a subordinated debt requirement are not likely to be good substitutes for the broader range of criteria outlined in Basel Core Principles of Effective Banking Supervision. Giving huge credit lines to countries without any monetary policy conditionality seems counter-intuitive. The fiscal policy pre-condition is not discussed in a serious way in the Meltzer Report; it reads like an after-thought. More troubling still, freedom of entry for foreign banks and timely reporting of debt maturities will not get you out of a balance-of-payments crisis. Without measures to reduce absorption and to switch expenditure from foreign to domestic goods, the crisis country's ability to repay is not likely to improve. While I share the Meltzer Commission's desire to reduce the scope and intrusiveness of present Fund structural policy conditionality, this does not look like the best way to do it.

By the same token, I am not a big fan of the CCL. I believe the design flaws there extend beyond pricing and that it is possible to create a superior lending window to deal with the systemic cases of cross-country contagion along the lines outlined in the CFR Report (1999).

(ii) scope of conditionalilty -- Among the charges leveled at the IMF during the Asian crisis, none was probably more widespread than the criticism that the Fund has allowed the scope of its conditionality to become over-extended, particularly in the area of structural policies. The most recent visible manifestations of the "reach" of Fund programs were the much-publicized dismantling of the clove and plywood monopolies in the Fund's 1997 program with Indonesia, and the financial-sector and/or corporate governance reforms that were at the center of Fund programs with the Asian crisis countries. It is now not uncommon for performance criteria in Fund programs to include actions in any number of the following structural policy areas: financial-sector reform, privatization and public enterprise reform, social safety nets, tax and expenditure policies (including so-called "unproductive" public expenditures, like high military spending), labor market policies, pricing and marketing/distribution policies, agricultural policies, environmental policies, and policies to combat corruption and money-laundering. In addition, through its ESAF and its successor, the Poverty Reduction and Growth Facility (PRGF), the Fund in collaboration with the World Bank, has been deeply involved in efforts to promote sustainable growth and reduce poverty in low-income developing countries.

I suspect that at least four factors have been at work in generating the Fund's "mission creep."

(a) First, the break-up of the Soviet Union and the rise of democracy in eastern Europe brought forth a huge demand for structural reform in the transition economies. A market economy presupposes a market-friendly institutional and legal framework and that framework had to be built from the ground up in many of these economies. Since the Fund (along with the World Bank) was at the forefront of providing economic advice and financial support to those economies, it was not surprising that Fund programs with these countries contained many performance criteria related to structural transformation of the economy. In a similar vein, because the Asian financial crisis was marked by the collapse of banking systems and large-scale corporate debt-servicing problems, these programs too were apt to have an above-average structural component.[16] What is not straightforward is whether even in these "special" cases Fund programs went "too far." Even more so, these two regional transformations/crises do not explain why Fund structural performance criteria also went up in other regions/countries where there was no analogous (so pressing structural) transformation.

(b) Second, there is the "political" demand for structural performance criteria. This has several dimensions.

[16] See Goldstein (1998).

Because Fund conditionality brings with it substantial financial assistance, many interest groups in creditor countries -- running the gamut from the environment, to core labor standards, to exporters, to financial service firms, to human rights activists -- have come to the conclusion that they can get more leverage for their objectives if they can get them included as performance criteria or as potential deal breakers in Fund programs -- rather than pursue them through the agencies or IFIs with more specialized mandates but with less financial leverage or longer-term agendas (e.g. the International Labor Organization, international trading rounds, environmental treaties, etc). Perhaps the best example of such pressures is the very large number of Congressional directives that the US Executive Director in the Fund is obligated to follow by voice and vote. To the extent that such interest groups have legislative clout, they can place creditor governments in an awkward dilemma: rejecting the demand of these groups will permit the Fund to "keep to its knitting" but may not generate enough support to pass legislation giving the Fund the financial resources it needs (say, via quota increases or bilateral contributions) to carry out its main-line functions (e.g., crisis management); on the other hand, giving in to such pressures will multiply the number of performance criteria in Fund programs and move the Fund away from its core competence.

Another "political" demand for structural performance criteria can arise when a creditor government supports liquidity assistance for an economy in crisis but does not want to be seen as supporting the ruling party or head of government without concrete action against "cronyism" or measures in support of democratization. Such measures will often be seen as "public signals " that reform is underway and will be "even handed" -- even if these measures are not macro enough to have much influence on the overall balance of payments. Again, they will take the form of structural performance criteria (e.g., the withdrawal of a monopoly trading franchise from a widely-known crony of the prime minister, or the cancellation of a showboat project, etc) and they may be lobbied for directly by the creditor government.

Political demands for structural performance criteria can also come from the program country itself. Here, the reformers may reckon that the crisis is their once-in-a-lifetime chance to implement a long list of reforms for the economy that have met resistance during normal times. Many of these reforms may be desirable for long-term economic performance but are not necessarily directly related to overcoming the crisis itself. Still, they may press the Fund to "make hay while the sun shines."

(c) The Fund's concessional lending activities to poor countries can also generate some increase in structural policy conditionality. This is notwithstanding the fact that such lending is typically done in collaboration with the World Bank (who is supposed to take the lead on

poverty-reducing structural measures and the design of social safety nets). For example, the composition of cuts in public investment and public consumption can then become separate performance criteria (so as to protect the most vulnerable groups) along with improvement in the overall budget deficit.

(d) Last but not least, the Fund itself has probably been a source of additional structural policy conditionality, that is, not all of it is demand-driven from the "outside." It can seek to extend its mandate either to improve the bottom-line results of Fund programs, to close loops for evasion in a more limited set of performance criteria, or to preserve or increase its "turf" in the face of a changing global environment.

Whatever the origins of the wider scope of Fund conditionality, several concerns have been expressed about its impact on the effectiveness of and popular support for the Fund.
One is that wide-ranging and overly instrusive structural-policy conditionalilty will encourage countries to delay even longer in coming to the Fund, thereby magnifying the task of crisis management and resolution. A second concern is that this kind of conditionality will paint the Fund as insensitive to the cultural and social differences among emerging economies. Concern number three is that involvement by the Fund staff in areas outside their primary competence will weaken the Fund's reputation for professional, apolitical advice.

Feldstein (1998) has argued that when the Fund contemplates including a particular policy reform in its programs with emerging economies, it should ask itself two questions: is this reform necessary to restore the country's access to international capital markets? And would the Fund ask the same measures of a major industrial country if it were the subject of a Fund program? If the answer to either question is "no," then that policy should not be part of the Fund program.

The CFR Report (1999) concluded that the traditional separation of responsibilities between the Fund and the World Bank had become blurred in recent years-- to the disadvantage of both institutions and their clients. It recommended that the Fund confine the scope of its conditionality to monetary, fiscal, exchange rate, and financial-sector policies. This is the same "core competence" outlined for the Fund in a recent external review of Fund surveillance by a group of outside experts led by former Bank of Canada Governor John Crow (see Crow et al [1999]). Financial-sector policies (and surveillance) were included in the Fund's mandate under the rationale that banking and financial-sector problems were much more connected than other structural policy areas to the prevention, management, and resolution of financial crises. The CFR Task Force also recommended that the World Bank should concentrate on the longer-term structural and social aspects of economic development and should expand its work on social

safety nets. The Bank should not be involved in crisis management, or in emergency lending, or in macroeconomic policy advice.

As noted earlier, the Meltzer Report (2000) recommended that the IMF cease lending to countries for long-term structural transformation (as in the transition economies) and for long-term development assistance (as in sub-Saharian Africa). It would eliminate the PRGF. Long-term structural assistance to support institutional reform and sound economic policies would be the responsibility of the World Bank and the regional development banks (i.e., the Asian Development Bank, the African Development Bank, and the Inter-American Development Bank).

The US Treasury (2000) opposed the Meltzer Commission's recommendations that the PRGF be closed and that long-term assistance to foster development and sound economic policies be handled exclusively by the World Bank and the regional development banks. It emphasized that poverty reduction in poor developing countries will not occur without economic growth, and that good growth performance in these countries will not take place without sound macroeconomic policies. Since the Treasury saw the Fund's particular expertise in helping countries to set up appropriate macroeconomic frameworks as not being shared by the multilateral development banks (MDBs), it was opposed to transferring this responsibility from the Fund to the MDBs. Moreover, it did not feel that the Fund advice on macroeconomic policy would be influential in poor countries unless it was supported by some Fund lending arrangement. It also hinted that bilateral contributions funding the IMF's concessional lending activities might be cut back to some extent if the IMF were no longer involved in lending to poor countries. All this being said, the US Treasury (2000) did acknowledge that the IMF's role in concessional lending "... needs to change significantly." (p. 22) Specifically, it called within the PRGF for a clearer division of labor between the Fund and the Bank, with the Fund focusing on macroeconomic policy and structural reform in related areas (tax policy and fiscal management) and with the Bank taking the lead on national poverty-reduction strategies and [other] structural reforms.

For its part, the Fund continues to defend its lending activities to its poor country members. Fischer (2000b) argues that poor countries also have macroeconomic problems and that they have a right like every other member to access the facilities of the Fund. He also maintains the new PRGF will improve lending to the poor countries because it forces the Fund, in cooperation with the Bank, "... to make sure that the macroeconomic framework is fully consistent with what needs to be done for social reasons." (p. 4). Regarding the scope of structural policy conditionality, it may be too early to tell what

the new managing director of the Fund, Horst Kohler, will do. Nevertheless, recent press reports (*Financial Times,* July 2000) suggest that the new managing director is committed to having the Fund halt "mission creep," and that he wants to narrow the Fund's mandate by reducing the number of structural-policy performance criteria included in Fund programs.

In the recent G-7 Finance Ministers Report (2000), there is support for the Fund's role in the PRGF. The Report also notes that the issues dealt with by the Fund and the Bank are increasingly interrelated. It acknowledges that a "... clearer definition of their respective responsibilities and activities" would be desirable but doesn't provide any specific suggestions on what this definition should be. Indeed, it pretty much ducks the issue.

Given the political pressures -- particularly from its largest shareholders -- to maintain wide-ranging structural policy conditionality, I don't underestimate the practical difficulties of getting the Fund to adopt a leaner agenda. Still, I think it's a battle well worth waging. If future quota increases are not able to go forward without expanded conditionality side-payments, then the Fund should give consideration to funding itself in private capital markets.[17] For reasons laid out in both the CFR Report (1999) and the Crow Report (1999), I think the most sensible definition of Fund core competence is monetary, fiscal, exchange rate, and financial-sector policies; the rest should be the comparative advantage and primary responsibility of other IFIs. If, as reported, the new managing director of the IMF is moving in the direction of getting the Fund "back to basics," I applaud that effort. Also commendable was the decision of the Fund earlier this year to eliminate several lending facilities that are no longer needed (namely, the Buffer Stock Financing Facility, the contingency element of the Contingency and Compensatory Financing Facility, the Currency Stabilization Fund, and the Debt and Debt Service Reduction Facility).

I find unpersuasive the argument that if the PRGF were transferred to the World Bank, the Fund would be unable to have a significant influence on the macroeconomic framework in its poorer member countries. If the focus of the PRGF is really on long-term poverty reduction strategies, I think the Bank should take the lead role (including supplying the financing). To ensure that the Fund's voice on macroeconomic policies is heard loud and clear, there may be a need for a stronger "sign off" mechanism. Having the Bank create its own PRGF-type lending

[17] Another interesting proposal to counter "political" pressures on Fund lending decisions is to make Executive Directors on the Fund's Executive Board "independent" of their national governments -- following the lead of independent national central banks; see DeGregorio et al. (1999). The rub here is that I see no evidence that the larger industrial countries want to move in this direction.

window, as is sometimes suggested, hardly seems a good solution; why does the world need two windows to do nearly the same thing? Here, the institutional specifics of IFI lending facilities need to give way to a sensible and consistent division of labor -- not the other way around.

(iii) currency-regime and burden-sharing aspects of Fund conditionality -- Given the crisis events of the past several years, no discussion of Fund conditionality would be complete without addressing currency regime and private-creditor burden-sharing issues.

Among larger emerging economies with relatively open capital markets, the list of those that have been able to maintain a fixed exchange rate for five years or longer is now very short: Argentina and Hong Kong. During the past six years, Mexico, most of the Asian crisis countries, Russia, and Brazil (among others) have all been forced to abandon publicly-declared exchange rate targets of one kind or another. The main lesson that has been taken away from this experience is that emerging economies should choose either a regime of managed floating or a "hard peg" (i.e., a currency board or dollarization). Adjustable peg regimes (so-called "soft pegs") are now widely regarded as too fragile for a world of high capital mobility -- both because they offer no workable "exit mechanism" once the fixed rate becomes overvalued, and because there are strict limits to how long emerging economies can keep interest sky high in a currency defense (especially when the country has a weak banking system, or the corporate sector has a high debt-to-equity ratio, or the economy is in recession, or the government has a large fiscal deficit with a lot of floating rate debt). Despite these vulnerabilities, history suggests that some emerging economies will be tempted to try to maintain overvalued soft pegs if they think they can get large-scale IMF or G-7 financial support in a crisis; the Brazilian crisis in early 1999 was a leading case in point.

The Meltzer Commission (2000) recommended that countries avoid pegged or adjustable exchange rates and suggested that the IMF should use its Article IV consultations to make countries aware of the costs and risks associated with pegged or adjustable rates. The Report states that fluctuating exchange rates or hard pegs would be a better regime choice. It is noteworthy however that the Meltzer Report (2000) did not recommend that the IMF include the currency regime as one of the structural pre-conditions for IMF liquidity assistance, arguing that stabilizing budget and credit policies are far more important than the choice of exchange rate regime.

The CFR Report (1999) concluded that managed floating should be the Fund's main- line currency regime recommendation for emerging economies, with hard pegs also advocated in

particular circumstances.[18] It went farther however than the Meltzer Commission. Specifically, the CFR Task Force recommended that the IMF not provide large-scale financial assistance to countries that are intent on defending arguably overvalued fixed exchange rates.[19] In this sense, the CFR Task Force would make exchange rate policy an integral part of Fund conditionality.

The IMF also seems to share this consensus on currency regime choices for emerging economies. Fischer (2000b) noted that all the countries that recently had major international crises had relied on a pegged or fixed exchange rate system before the crisis. He also projected that "... we are likely to see emerging market countries moving towards the two extremes, of either a flexible rate or a very hard peg -- and in the long run, the trend is most likely to be towards fewer currencies." (p. 10).

The US Treasury has likewise endorsed the "corners" view of currency regimes for emerging economies. Summers (1999) has stated that countries maintaining a fixed rate should be expected to make explicit the extent to which monetary policy is being subordinated to the exchange rate objective, and (if using fixed rates as a tool of disinflation) to disclose the nature of their exit strategy. He concludes that "... countries that are involved with the world capital market should increasingly avoid the 'middle ground' of pegged rates with discretionary monetary policies, in favor of either more firmly institutionalized fixed rate regimes or floating." (p. 4).

In my view, the "corners school" consensus on currency regimes for emerging economies is soundly based on the lessons of experience. The key question is whether the G-7 and the IMF are prepared to act on that recommendation when push comes to shove by not providing large-scale support for defense of overvalued fixed rates. I don't think merely advising emerging economies on choice of regime in Article IV consultations (as recommended by the Meltzer Commission) will get the job done.

On the conceptual level, we also need to understand better why so many emerging economies exhibit a serious "fear of floating," as documented in several recent empirical papers.[20] One explanation is history, that is, a long memory by domestic and foreign creditors of earlier periods of high inflation (and sometimes, also negative or very low real interest rates). This memory can lead private creditors to think that any temporary easing of monetary policy means

[18] Under the Fund's existing Articles of Agreement, countries can choose any currency regime (with the exception of linking the currency to gold). But this does not mean that the Fund cannot ask countries to follow a particular exchange rate policy as a condition for Fund financial assistance.
[19] A sizeable minority (11 of 29 members) of the CFR Task Force also took the view that there could no stability for emerging-economy currency regimes and no international financial stability more broadly until there was greater stability in G-3 currency relationships. Toward that end, they proposed a "target zone" plan for the G-3 currencies. The majority of the task force, however, rejected this approach.
[20] See, for example, Calvo and Reinhart (2000).

the authorities are again “off to the races.” Brazil’s recent post-crisis experience, however, with managed floating cum inflation-targeting and an independent central bank, suggests that history need not be insurmountable. A second and more weighty explanation is that many of these economies have large, unhedged, foreign-currency denominated liability positions on the part of banks and/or corporations; given that mismatch, a large depreciation would make many banks and firms insolvent, with large adverse effects on the real economy a la the Asian crisis. Here, dollarization is seen as a sensible “second best” policy choice -- given the difficulty of reaching the first best policy, namely, reducing or eliminating the mismatch itself. To me, however, the usual arguments put forward as to why the first-best policy option is not available (e.g., private capital markets will not lend to emerging economies in their own currency) are not convincing. As such, I still regard managed floating -- probably with inflation-targeting as a nominal anchor -- as the preferred choice in most circumstances.

I suspect that the choice between the two corners over the next few years will depend heavily on the real-life experiment now going on in Latin America. If Argentina’s currency board blows up because it does not have monetary policy available to help it emerge from its near recession, then the momentum for currency boards and dollarization will fade in favor of managed floating. On the other hand, if Brazil is unable to sustain its recent progress and inflation and/or the exchange rate runs out of control, then managed floating could well become a relic for most emerging economies. We will see who wins the horserace; right now, I would bet on Brazil (managed floating).

Turning to private-creditor burden-sharing -- or PSI (private sector involvement) -- the aim is to see that private creditors do not escape from paying their “fair share” of the burden of crisis resolution. As outlined earlier, the worry is that if private creditors do not “take a hit” when they make poor lending and investment decisions, there will not be sufficient incentive to undertake more careful risk assessment in the future.

Judging from the recent Report of G-7 Finance Ministers (2000), recent Congressional testimony by US Treasury Secretary Summers, and a recent progress report on IFA reform by the IMF (2000a), the official sector (at least in the major industrial countries) feels it is making real progress on PSI. In this connection, the G-7 Finance Ministers (2000) have noted that “... private sector investors and lenders have been more involved in the financing of recent IMF-led programs.” (p. 2). Similarly, in listing recent important achievements on the reform of the IFA (in testimony before the House Banking Committee in March of this year), Secretary Summers stated that “... we have found new ways to involve the private sector in the resolution of crises -- most notably in the cases of Korea and Brazil (pp. 2-3). And an IMF (2000a) progress report observed

that: “... two recent cases of efforts to secure private sector involvement with members that had lost spontaneous access to capital markets through the restructuring of international bonds had been encouraging” (p. 14); later on, however, that same IMF report also acknowledged that “... only limited progress has been made in lifting institutional constraints to debt restructuring.” (p. 17). The references above are to the less than voluntary rollover (albeit with a government guarantee and interest rates 150-200 basis points higher than pre-crisis rates) of interbank credits by G-7 commercial banks in South Korea in early 1998, to the voluntary rollover of interbank and trade lines in Brazil in March 1999, to a tougher stance by the IMF and/or the Paris Club in several recent (1999 and 2000) emerging-market bond restructurings (Ecuador, Nigeria, Pakistan, Romania, and Ukraine), and to rather limited success in encouraging creditor committees and inclusion of “collective-action clauses” (hereafter, CACs) in sovereign bond contracts (at least among the G-7 countries).

Enough to say that some private analysts do not share this (rosy) assessment. Eichengreen (2000), for example in a recent comprehensive review of PSI efforts of the past few years, concludes that efforts to significantly enhance the participation of the private sector in crisis management and resolution have so far been a “failure,” and characterizes recent progress as “halting.” He also argues that to do better on PSI, it will be necessary to add both CACs and internationally-sanctioned standstills to the official arsenal.

The Meltzer Report (2000) took a decidedly hands-off approach to the PSI issue, nothwithstanding its concern about lender moral hazard. It concluded that: “... the development of new ways of resolving sovereign borrower and lender conflicts in default situations should be encouraged but left to participants until there is better understanding by debtors, creditors, and outside observers of how, if at all, public-sector intervention can improve negotiations.” (p. 50).

In contrast, the CFR Report (1999) took a more activist position on PSI. More specifically, the Report recommended: (i) that all countries -- including the G-7 countries -- commit to including CACs in their sovereign bond contracts and require that such clauses be present in all new sovereign bonds issued and traded in their markets; (ii) that the IMF advise all emerging economies to adopt a ‘structured early intervention and resolution’ approach to deposit insurance reform in their banking systems and reward countries that do so; (iii) that the IMF make it known that it will provide emergency financial assistance only when there is a good prospect of the recipient country achieving ‘balance of payments (BOP) viabililty’ in the medium term (including a sustainable debt and debt-servicing profile); that, in extreme cases of unsustainable debt profiles, the IMF expect as a condition for its support that debtors engage in good faith discussions with their private creditors with the aim of reaching a more sustainable debt profile;

and (iv) that the IMF recognize that orderly debt rescheduling may be facilitated by having the debtor declare a temporary payments standstill (with the final decision to impose the standstill resting with the debtor country -- not the IMF).[21] The aim of the CFR approach was to reduce lender moral hazard at the national and international level and to promote timeliness and orderliness in private debt rescheduling -- but without going so far as to promote borrower moral hazard.

The IMF, US Treasury, and G-7 Finance Ministers all seem to favor a differentiated case-by-case approach to PSI, guided by a few principles. They also favor some institutional changes but are not very specific about what they are willing to do to make these changes come about. The recent G-7 Finance Ministers Report (2000) illustrates the state of play. They say that the IMF should "encourage" use of CACs to facilitate more orderly crisis resolution but don't indicate what form this encouragement should take. Similarly, they say that use of CACs in international bonds issued by emerging economies in G-7 financial markets should be "facilitated" but don't say how. They recommend different approaches on PSI depending on the borrowing country's medium-term debt and balance-of-payments profile. Where that profile is sustainable, they prescribe catalytic official financing and policy adjustment, or voluntary approaches to overcome creditor coordination problems. Where the debt and BOP profile is unsustainable, a broader spectrum of actions by private creditors -- including comprehensive debt restructuring -- is regarded as appropriate. If there is any "tilt" in the policy line, perhaps it is that countries with unsustainable debt and BOP profiles should be told "at the start of the process" of the "consequences" of any failure to secure the necessary contribution from private creditors (p. 10). These consequences could include the need for stronger program adjustment, the option of reduced official financing, or conversely, the decision by the IMF to "lend into arrears" if the country has suspended payments while seeking to work cooperatively and in good faith with its private creditors and is meeting its other program requirements.

Unlike the Meltzer Report, I do not believe that the PSI problem will solve itself in the marketplace. Also what the official sector does on PSI inevitably influences the balance of power between official debtors and private creditors in debt negotiations (as the IMF implicitly acknowledged in the late 1980s when it finally endorsed selective use of IMF "lending into arrears" to private creditors). As argued in the CFR Report, I think the G-7 countries will need to be more activist in facilitating wider use of CACs in sovereign bond contracts, as well as in endorsing selective use of temporary standstills. The decisions by the United Kingdom and

[21] Only one of the 29 members of the CFR Task Force (namely, William Rhodes of Citigroup) dissented from the private-sector burden-sharing and CAC recommendations.

Canada to include CACs in some of their sovereign bond contracts is welcome; other G-7 countries should now follow their lead. Recent empirical work by Eichengreen (2000) suggests that the worry that such measures will raise the cost of borrowing for emerging economies (with good credit histories) seems not to be well grounded (that is, the benefits of avoiding a creditor grab race outweigh the borrower moral hazard effects). In addition, in cases of unsustainable debt profiles, the official sector will need to insist on appropriate debt restructuring with private creditors as a condition for IMF financial support. Thus far, IMF inclination to take that position has been evident only in small-country cases. The unanswered question is whether the official sector will be prepared not to put its money where its mouth is in a large-country case. Finally, but probably most important, the IFIs need to push much harder on emerging economies to put in place "good" deposit insurance systems; most lender moral hazard occurs at the national level -- not at the international level and this will continue until incentive-compatible financial safety nets are in place.[22]

(iv) implementation of international financial standards -- It is widely recognized that the elements of IFA reform discussed thus far in this paper are not likely to have much of an impact on crisis prevention in emerging economies unless those economies also undertake a broad and determined effort to strengthen their domestic banking and financial systems. After all, over the past 15 years, there have been more than 65 episodes where banking problems in emerging economies got so bad that the entire banking system was rendered insolvent. In the Asian crisis countries, we are now looking at fiscal costs of bank recapitalization that range from 10 to 60 percent of GDP.[23]

One of the key mechanisms being used to guide this upgrading of financial systems in emerging economies is international financial standards. Each of these standards is drawn by an international group of experts and represents agreement on what the minimum requirements for good practice are. The FSF has now decided that 12 of these standards are crucial for sound financial systems and deserve priority implementation. The 12 key standards (known as the "Compendium of Standards") cover data dissemination; banking supervision; insurance supervision; securities regulation; insolvency regimes; corporate governance; accounting; auditing; payment and settlement; market integrity; fiscal policy transparency; and monetary and financial policy transparency.

[22] By a "good" deposit insurance system, I mean one that puts large uninsured creditors of banks at the back of the queue when failed banks are resolved, that places stringent accountability conditions on senior economic officials when they invoke "too large to fail," and that gives banking supervisors better protection against strong political pressures for regulatory forbearance.
[23] See World Bank (2000).

Establishing standards is one thing. Getting countries to implement and enforce these "voluntary" standards is another. In seeking to identify incentives that would speed the implementation of international financial standards, the official sector has relied on three channels.

First, there is the expected market pay-off. If market participants can tell who is and who is not implementing the standards and if complying countries are regarded as more creditworthy, then the latter should be the beneficiaries of a lower market cost of borrowing. Early on, there was some hope that the private credit rating agencies might take up the task of evaluating compliance with standards and publish the results. That has not happened. Instead, it is the official sector -- and primarily, the IMF -- that has taken the lead in this process. A few examples illustrate the process. The Fund now posts on the Internet the list of countries that have signed on to the data dissemination standard. Similarly, for the banking supervision standard, the Fund prepares Reports on the Observance of Standards and Codes (ROSCs); so far, ROSCs for about 15 countries have been completed and another 20 or so are under preparation. Both the decision to have a ROSC and to have the report published are at the discretion of countries; the majority of completed ROSCs have been published. The Fund and the World Bank jointly produce Financial Sector Assessment Programs (FSAPs) that evaluate financial-sector vulnerabilities as well as assess compliance with those financial-sector standards that affect stability. World Bank staff expect to have about six corporate governance and six accounting reports available soon.[24]

Two factors have constrained the market pay-off channel. One is the concern that naming publicly the non-complying countries could precipitate runs or crises. Recently, however, that concern appears to be waning. Within the past few months, the FSF published the list of offshore financial centers whose regulatory and supervisory practices are regarded as "lax"; the OECD named jurisdictions that promote harmful tax competition; and the Financial Action Task Force identified 15 jurisdictions that were judged to be uncooperative in the fight against money laundering. This recent public "naming of names' could be ushering in a more aggressive stance by the official sector. The other constraint is that evaluation of compliance in areas outside the competence of the IMF and the World Bank presupposes a good deal of inter-agency cooperation and coordination. This still remains a bottleneck.

The second incentive channel for implementation of financial standards is the Bretton Woods channel. More specifically, the IMF and the World Bank could give those countries implementing the standards a better insurance deal (larger access or lower interest rates) when they needed financial assistance. This still appears to be on the drawing board. Implementation of

financial standards is supposed to be one of the eligibility factors for accessing the CCL, but as mentioned earlier, no country has yet applied for CCL assistance.

Potential incentive channel number three is the regulatory channel. Bank loans to countries implementing the standards could qualify for a preferred risk weight under the revised Basel Capital Accord (which sets minimum capital requirements for internationally active banks). In fact, the proposed revision of that accord does stipulate that countries can't get the best risk weight unless they are judged to be implementing several of the key standards. Again, however, this still seems to be a way off since the revised Accord has not yet been agreed.

The US Treasury and the G-7 Finance Ministers look to be on the same page on where they want to go with the standards. In brief, they are encouraging countries to sign up for assessments of compliance with the standards and to allow the results to be published; in addition, they are encouraging the IMF to identify which standards should have the highest priority for which countries. They are also asking the FSF to see if there are farther supervisory and regulatory incentives that would promote observance of the standards.

The Meltzer Report (2000) took a different tack. It recommended that financial standards should be set by the Bank for International Settlements (BIS) and that implementation of standards, and decisions to adopt them, should be left to domestic regulators and legislators.

In contrast, the CFR Report (1999) called on the IMF to monitor countries compliance with standards (at least the ones that fall into its core competence) and to charge lower interest rates to countries that make better crisis-prevention efforts, where implementation of standards would be one of the key elements in "crisis prevention efforts." Furthermore, the Report urged that this risk-based insurance premium apply to all the Fund's nonconcessional lending -- not just to the CCL. In addition, the CFR Task Force recommended that the Fund publish its evaluations of compliance with standards so that the markets could take note.

Implementation of international financial standards is one of the areas in IFA reform that has shown the most progress over the past few years.

The Meltzer Report (2000) recommendation to have domestic regulators evaluate compliance with standards is a bad idea. It is very unlikely that such self evaluations will be objective rather than self serving. In this connection, a survey sent to 129 countries in 1996 by the Basel Committee on Banking Supervision is instructive; on element after element of banking supervision (from government-directed lending, to loan classification procedures, to independence of the supervisory agency etc.), a very high proportion of respondents ranked themselves as doing a very good job -- and this despite the sorry record of banking crises over the

[24] See IMF (2000a).

preceding twenty years, to say nothing of the banking crises to come (just a year or so after the survey) in Asia.[25] I would argue instead that assessment of compliance with international financial standards should continue to be done by (more objective) international agencies with the relevant expertise (at least until the private sector is prepared to take up that task in a serious way). The recent decisions by the FSF and other official agencies to publicly "name names" of non-complying economies suggests that they have "crossed the Rubicon" on this issue. This should increase the market payoff to implementing the standards.

The next bottleneck that needs to be tackled is better coordination among the evaluating agencies. It would be very helpful to have assessments on all 12 of the key standards included in the Compendium collected together and published in one place, say in the IMF's Article IV consultation report. In addition, the IMF, World Bank, and the FSF should move forward to strengthen the Bretton Woods and regulatory incentive channels for compliance with standards.

CONCLUDING REMARKS

More has been happening on reform of the IFA over the past 5 years than many people think. But progress has been quite uneven. Progress has been considerable in the setting and implementation of international financial standards and in transparency and disclosure (including the transparency of the IMF itself). Currency regimes for emerging economies have likewise improved, although that has been forced by the market -- not by the official sector. Judging from recent pronouncements, the redesign of Fund lending facilities also appears to be moving in the right direction. Much less progress has been made, however, on PSI and on refocusing the mandates of the IMF and the World Bank. That is where the priority needs to be over the next year or two.

On PSI, the top priority should be to get in place a sensible system of deposit insurance for banks in emerging economies. That is where the bulk of the lender moral hazard problem now resides. Next in line on PSI should be efforts to cut back on the size of IMF rescue packages for country crises and to move toward a more rules-based approach for defining systemic crises and for activating larger resources. More attention to CACs and creditor committees, and to internationally sanctioned standstills (in extreme cases), would also pay dividends.

The former managing director of the Fund, Michel Camdessus, was fond of saying, "The Fund should do more and do it better." I would argue the Fund should do less so that it can do it better. Comparative advantage should apply to the IFIs as well as to their member countries. A way needs to be found to resist the constant calls on the Fund to become a "general purpose organization." Its core competence in monetary, fiscal, exchange rate, and financial-sector

[25] See Goldstein (1997) for a discussion of the survey results.

policies should be protected; this will require the cooperation of the membership -- and particularly of the largest shareholders. It will also require firmness from the Fund's new managing director to see that safeguarding financial stability is paramount among the Fund's objectives. None of this means that the Fund should not take account of social needs in its programs or that the Fund cannot provide good service to its poorer member countries (any more than making price stability the key objective of central banks means that they should ignore the real economy or financial stability). But it does mean that both the Fund and the World Bank have to allow their 19th Street partner to lead in the areas of its comparative advantage, as well as rationalize their lending windows.

* * *

Postscript

Since this paper was written, there have been several developments in the IFA worth mentioning.

In mid-September 2000, the IMF's Executive Board agreed to make some changes to the Fund's non-concessional lending windows. The main components of this so-called "facilities initiative" are as follows:[26] (i) repayment maturities have been reduced for stand-by arrangements (from the previous 3 ¼ to 5 years, to 2 ¼ to 4 years) and for EFF arrangements (from the previous 4 ½ to 10 years, to 4 ½ to 7 years); (ii) an interest rate surcharge has been added for "large" IMF loans (100 basis points at 200 percent of quota, rising to 300 basis points about 300 percent of quota); (iii) an effort has been made to make the CCL more attractive to borrowers, by reducing the interest rate surcharge (from the previous 300 basis points to 150 basis points), by reducing slightly the commitment fee, and by both making monitoring arrangements less intensive and the activation review less demanding; (iv) access to the EFF is to be made more selective, confining it to cases where longer-term financing is clearly required; and (v) the Fund will engage in "post-program monitoring" of economic developments and policies for countries that have credit outstanding to the Fund of 100 percent or more of quota at the end of an IMF program.

On September 26, 2000, the IMF's new Managing Director, Horst Kohler (2000), delivered his long-awaited Annual Meeting speech. He reiterated his view that "less could be

[26] For further details, see IMF (2000b).

more" on Fund conditionality, although he provided fewer specifics than expected on just how this could be done.

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