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By
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Illustration by
D. B. Johnson

Inoculating Against the Financial

IN DECEMBER 1994, Mexico, the darling of international investors since its recovery from a debt crisis in 1982, suddenly experienced a severe financial downturn. It was feared that the crisis would spread to the rest of Latin America and perhaps threaten the international financial system. Although the United States Congress was balking at providing the funds to avoid a default, the Clinton Administration, together with the International Monetary Fund (IMF) and other international financial institutions, provided adequate emergency funding. After much belt tightening and a deepening misery of the poor, Mexico recovered.

The scare of 1994 prompted much academic analysis of what had been learned from the Mexican peso crisis. There was also a great deal of concern on the part of industrialized countries' central banks and finance ministries about what the West chooses to call "sovereign liquidity crises." However, the international community did not pay sufficient attention to prevent or even foresee what was just around the corner: that a minor financial crisis in the Thai baht in July 1997 would spread from Thailand to South Korea to Indonesia to Russia, where it—along with Russia's indigenous troubles—created a major financial meltdown last August. By September, Brazil, too, was threatened by the flu, and George Soros

How to stop the spread of monetary crises in emerging-market countries

was publishing in the *Wall Street Journal* his planned testimony to the House Committee on Banking and Financial Services under the title "The Crisis of Global Capitalism."

At this moment, the world's focus is 100 percent on what can—or should—be done to stanch the deepening financial failure. Yet, the international community also needs to do what it *should* have done after Mexico demonstrated the dangers of accessing highly volatile and instantaneously moveable capital markets: reach international agreement on how to allow emerging markets access to foreign capital

Flu

markets without jeopardizing global financial stability.

What sort of domestic economy can withstand currency runs? If the international community can agree on what internal measures a domestic economy that is *less* vulnerable to capital outflows loans needs to have, how can the borrowing country be encouraged to adhere to those standards? If the standards being articulated are for how to regulate banks and securities markets, what *is* the connection between currency crises and *domestic* banking and financial regulatory systems?

The Crux of the Matter

Two factors explain why the strength of the domestic financial regulatory system is key to preventing sovereign liquidity crises. The first is the ambiguous role of financial intermediaries in a liberalized market economy.

Privately owned financial intermediaries are similar to private companies in any market system. Their prime aim and their *raison d'être* is to make money for their owners so their owners will reward their managers handsomely. To make money in a market system is to take risks—carefully calculated risks. (In the case of banks—to wildly oversimplify—the chief risk is found in the various gaps between a bank's funding, the interest rate at which it borrows, the currencies in which it borrows, the maturities of its borrowing, and the cost of its equity, on the one hand, and, on the other hand, the bank's investments, the interest rate at which it lends, the currencies in which it lends, the maturities of its lending, and the amount of capital, equity or equity-like it has to tide it over gaps that widen unexpectedly.)

In a market economy using private entities as its pistons, the control over the degree of risk incurred in the search for gain is the fear of failure and the owners' loss of their investment. However, private banks perform quasi-public functions in market economies. They are repositories for the savings of the public. They are also administrators of the payments system and the levers by which macro-economic monetary policy set by the government or the central bank is transmitted. Simply stated, governments feel special constraints against allowing banks that misgauged risk to fail.

The owners and managers of private banks are aware of this privileged position and come to count on being "bailed out," and the public, placing its deposits in banks (that is, funding the banks), does not exercise an investor's discipline over the entities. That is because the public does not have access to sufficient information about the relative riskiness of each individual bank's business to choose among them. And why should it, in a system where the government, to give these quasi-public entities preferred access to public saving, has guaranteed repayment of at least a portion of deposits?

This dilemma, of using privately owned entities to funnel household savings from the public to productive enterprise and so being reluctant to let these intermediaries fail, is known by the funny name of "moral hazard." The dilemma exists for modern industrialized economics, as recently illustrated for the United States by the savings and loan debacle and for Europe by the Scandinavian banking crisis. It is particularly acute in emerging market economies that have liberalized their capital accounts and do not restrict or at least oversee hard currency borrowings by their intermediaries.

The financial commentator of the *Financial Times,* Martin Wolf, published a brilliant analysis called "Why Banks Are Dangerous," in which he points out that a central bank cannot be a lender of last resort in a foreign currency. Neither can its government insure foreign currency deposits. If an intermediary in an emerging market economy borrows in a foreign currency and then lends to its borrowers either in the national currency or in the foreign currency, it has incurred foreign exchange risk (sometimes called "transfer risk"). If the intermediary has lent in the national currency, it (that is to say, its government, which has explicitly or implicitly guaranteed its liabilities) has run the risk that its borrower will repay in a depreciated or devalued national currency. If the intermediary has lent in the foreign currency, its own borrowers, who have to get the foreign currency to repair their loans, may not be able to do so. But its borrowers' defaults do not excuse the intermediary from having to repay its own hard-currency borrowing in now more expensive hard currency—or use up its government's reserves to avoid default. If it has lent to a domestic borrower in the foreign currency, the domestic borrower's ability to pay both interest and principle is severely affected by the depreciation of the local currency.

The uncovered foreign currency borrowing by the emerging market financial intermediaries has put the country whose currency may be entering a crisis at risk of having to use its foreign currency reserves to support its domestic banking system. This may occur just when the country needs its reserves to support its exchange rate against the specula-

tive attacks on the oversupply of its currency that is created when foreign investors sell out and go elsewhere. The more the country has supported its domestic banking system with deposit or other guarantees explicit or implied, the more the country must act as if those guarantees will be honored. It must do so to avoid adding a domestic run on financial institutions to the sudden outflow of foreign investment. As the *Financial Times* put it: "Foreign direct investment is invaluable. But easy private-sector access to short-term borrowing can be lethal."

The second factor as to why the strength of the domestic banking sector is key to a government's capacity to deal with a currency crisis lies in an absolutely traditional remedy for meeting capital outflows: raising the domestic interest rate (thus meeting the competition from greater rates of return in other markets). Unfortunately, this macro-economics move puts severe pressure on weak banks trying to roll over their funding and on struggling corporations with floating rate loans. Thus the robustness of the financial sector is key to the government's most useful tool to counter the effects of volatile capital outflows.

MOVING TOWARD A UNIFIED STANDARD

From a June 1996 summit meeting of a group of industrialized nations known as the G-7 came a call for coordinated international efforts to develop a set of "best practices" in the area of banking regulation and supervision. A variety of international institutions responded, in particular the Basle Committee on Banking Supervision. Together with a consortium of emerging-market countries, the Basle Committee in 1997 released standard-setting guidelines called the Core Principles for Effective Banking Supervision.

These guidelines promulgate sound banking practices. What makes the Core Principles unusual is the Basle Committee's proposal that emerging-market economies undergo biannual reviews to ensure that they are implementing and adhering to the principles. The notion of a coordinated supervisory review is the first hint of concern for how to achieve compliance with an international standard when one is developed and agreed upon.

The question will be the extent to which review by supervisory peers will be effective in shaming noncompliant countries to do better. Morris Goldstein, author of *The Case for an International Banking Standard,* makes the point that an international banking standard such as the Core Principles "lends further credibility to banking reform efforts—much in the same way that IMF support lends credibility to national stabilization programs." Presumably, the approbation of one's peers at the biannual meetings will aid the efforts of those countries honestly struggling to reach the standard, even if the shame is not a sanction for those who are noncompliant.

Before, however, concluding discussion of the issue of achieving compliance with international norms of banking regulation, it is necessary to mention another international study on avoiding financial crises in emerging-market economies. In its reach, the study went well beyond the work of the Basle Committee and its associates in developing the Core Principles. The study is explained in a report titled "Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption, and Implementation of Sound Principles and Practices to Strengthen Financial Systems." Prepared by a working party of the G-10, another consortium of nations, the report covers not only the contribution to financial stability of transparent, fair, and efficient capital markets, but also the need for high quality accounting systems, "sound and up-to-date systems for risk management by securities firms," suggestions for the role of the IMF and the World Bank, and above all, the importance of market discipline and market access channels.

The report is of extreme interest. Unfortunately, the international community did not have time either to absorb it or to use it as a prophylactic against this year's Asian financial crisis; events overtook the slow processes of international cooperation. One may speculate, however, that the existence of the report made the IMF's task somewhat easier in recent months. After all, when the IMF insisted on financial reform as a condition of its aid programs to Thailand, Indonesia, and Korea, it was dealing with some of the same officials who had participated in the G-10's working party. As such, they were already "on board," so to speak, concurring with the need for instituting the practices of good governance, supervision, and regulation suggested in the report.

THE MATTER OF COMPLIANCE

Now the question is, how does the international community ensure that emerging markets adopt the strategy? The norms and best practices developed by the Basle Committee and the G-10 are not "international law." The working party's report is very clear on this. It describes the consultative process by which, in the financial arena, norms of best practice are developed and then adds, "A formal endorsement may give the recommendations greater weight. However, they have no legal home until they are adopted by national authorities. They derive their authority from the expertise of those that have formulated them and their wide acceptance from the consultative manner in which they are prepared. They come to be applied because they reduce risk, improve market functioning, and foster a level playing field. If the conventions or norms are not observed, market participants exact a risk premium."

How, then, is it possible to persuade national authorities to adopt an international banking standard; provide oversight of domestic capital markets that ensures their transparency, fairness, and efficiency; and force domestic corporations to adhere to norms of good governance?

It is only when a country is in the throes of a financial crisis that the international community has a method to insist on the adoption of norms of financial structural reform, banking supervision, and securities market oversight. The country, having lost access to the capital markets and unable to pay its debts, turns to the IMF and the G-7

countries for aid. As a condition of the extension of its credit, the IMF imposes the reforms the community has now agreed upon as the necessary concomitant of the return to financial health.

IMF conditionality, however, does not aid in the real purpose of the development of international norms, that is, *prevention* of sovereign liquidity crises. Emerging-market nations are under no international law obligation to follow whatever consensus develops on financial supervision practices. The IMF's governing treaty assumes that countries will meet capital outflows, although as the Asian crisis arrived, the IMF was debating amending the treaty to be anticapital controls. Last February Federal Reserve Board Chairman Alan Greenspan called publicly for putting sufficient preventative measures in place to ward off crisis number three (Mexico being number one and Asia number two). Such measures, however, can only be put in place by national governments.

The working party report seems to suggest that the desire to be able to access the international capital markets will encourage countries to adopt the standards. "Once principles for sound practices have been established, markets can provide important incentives for their adoption," the report states. "For example, emerging market economies that implement widely accepted norms will gain improved access to the international capital market and may obtain sizable reductions in funding costs." This may be true, but one needs to ask where markets get their information. The major international rating agencies did not downgrade the ratings for the public debt of Korea, Thailand, and Indonesia until considerably *after* the crises had begun. It seems fair to say that whatever the agencies base their country analyses on, it is surely not an in-depth study of the quality of banking supervision in emerging markets. The global mutual funds are not a source of discipline; the aim of any such fund when sentiment shifts is to be first out the door.

A Model Idea

In *The Case for an International Banking Standard*, Goldstein recognized the insufficiency of leaving compliance up to national regimes and made a concrete suggestion for obtaining compliance that strikes this author as exemplary. He begins with a reference to an already existing mechanism, the

To make money in a market system is to take risks—carefully calculated risks.

Special Data Dissemination Standard (SDDS), which was put in place by the IMF after the Mexican peso crisis. The crisis brought home to the IMF the lack of access by the capital markets to reliable governmental data. It thereafter established a standard for the statistical format in which countries seeking access to international capital markets must make public their economic and financial data. (The Fund is also working towards completion of a similar standard to guide all its members.)

The most interesting aspect of the SDDS, however, is not the standard itself, but the system that the IMF put in place to try to ensure that countries accessing the capital markets actually adhere to the standard when providing information to the markets. First, all IMF members were invited by the managing director to subscribe to the SDDS. Second, the IMF created an electronic bulletin board listing subscribing countries together with their data and dissemination practices. There has been a transition period—from the opening of the subscription in April 1996 until December 31, 1998—during which time IMF members could subscribe even if their dissemination practices did not fully meet the standard. Only egregious nonobservance would be grounds for removal. At the present time, forty-three countries have been listed as subscribers.

After the transition period, subscribers can be removed for serious and persistent nonobservance. Procedures for removal could involve a panel of independent experts and would require a decision by the IMF executive board. The implication is, of course, that removal would entail the imposition of a market premium on borrowing by the offending country.

The IMF model is the basic structure suggested by Goldstein for achieving compliance by countries with an international financing standard. Once the norms of best supervisory practice are worked out by the international consultative process, he would have the IMF (and possibly the World Bank) create a similar list of subscribers to the international banking standard. Since the IMF regularly has teams in all emerging-market countries as part of its surveillance responsibilities, Goldstein suggests that the teams could inspect the domestic banking supervision mechanisms for compliance with the standard. Since subscription to the standard would be voluntary (with the carrot being, presumably, a better rate for the country's interbank borrowing and other forms of access to the capital markets), the IMF inspection could not be considered intrusive. Whether the subject is arms control, the disposal of uranium, or banking supervision, inspection by an international agency is acceptable today in the greater interest of nonproliferation, whether it be of nuclear material or financial instability.

There will, of course, be myriad details to be worked out, in particular, the exact procedures for de-listing, which is the most serious penalty for noncompliance. It is even conceivable that an appellate body might have to be created to reconsider a subscriber's removal from the list. As of this writing, the detailed legalistic dispute resolution system of the World Trade Organization, including an appellate body, seems to be working just fine. Why should the international monetary system not benefit from novel ways to ensure national compliance with international standards as well? ■

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