

Strengthening the Architecture of the Global Financial System

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Previous summits have focussed on ways to strengthen the global financial system. Over the past four years considerable progress has been made in the face of rapid globalisation and technical change in developing and implementing specific recommendations. However, the process of globalisation and recent events in Asia have revealed a number of weaknesses and vulnerabilities in national and international financial systems, as well as in the borrowing and lending practices of banks and investors. We therefore need to act to strengthen the global financial system, both to reduce the likelihood of such crises occurring in future and to improve our techniques for handling crises when they do occur.

This report presents proposals where there is now an emerging consensus for modifications to the architecture of the international financial system. It does not, however, complete the process. There are important aspects of the issues discussed that require further work. Discussion within our countries, with emerging market countries and other interested countries, with the International Financial Institutions (IFIs) and with the private sector will continue over the coming months.

We have identified the need for action in five key areas:

- Enhanced transparency
- Helping countries prepare for integration into the global economy and for free global capital flows
- Strengthening national financial systems
- Ensuring that the private sector takes responsibility for its lending decisions
- Enhancing further the role of the IFIs and cooperation between them.

This report outlines how work is being taken forward in each of these areas and signals a number of areas for further work.

Broad-based prosperity and growth require financial institutions, commercial enterprises and entrepreneurial individuals that are prepared to take risks. Risk inevitably involves the possibility of failure. We could not and should not seek to eliminate failure entirely; rather, large financial systems need to be robust enough to accommodate the occasional

failure and to contain risks which might threaten the whole financial system. And borrowers and lenders, be they governments, companies or individuals should be responsible for their decisions and actions. The principles and measures set out below are designed to help meet these objectives.

This report focusses on a range of areas where specific changes could help prevent and handle future crises. This focus should not undermine the important message that, as far as individual countries are concerned, the pursuit of sound economic policies that promote sustainable broad-based non-inflationary growth is the most important single contribution to avoiding a crisis. And when countries implement an International Monetary Fund (IMF)-supported reform programme, their commitment to and ownership of the programme is crucial to its success. Sound policies need to tackle structural economic issues so that sufficient provision is made for the poorest sections of society and other vulnerable groups, development is sustainable and living and working standards for all are improved. This is also key to securing the support needed for successful economic reform. In this respect we also encourage the IMF and Multilateral Development Banks (MDBs) to work with the International Labour Organisation (ILO) to promote core labour standards and with the competent international institutions to promote sound environmental standards.

Transparency

Disclosure of data and information

Accurate and timely economic data are essential for prudent economic management, improved risk assessment by investors, enhanced market stability, and effective surveillance. The Asian crisis has revealed the need, for example, for better and more timely information on countries' official international reserve assets and reserve-related liabilities and on the short term external assets and liabilities of the financial sector.

Work is underway to improve the timeliness and accuracy of data.

- We welcome the efforts of the Bank for International Settlements (BIS), working with national authorities, to continue to speed up the

collection and publication of data on the level of external bank exposure and to improve the quality of the data.

- The IMF should continue to look at ways of encouraging its members to provide transparent data, including, for example, through its surveillance work and in particular by encouraging countries to subscribe to its Special Data Dissemination Standards (SDDS). It is working to update the standards to include internationally comparable measures of reserves, the external exposure of financial sectors and indicators of financial sector stability. It should examine the best approach for improving the quality of data on external debt of the corporate sector. It needs to ensure that member countries subscribing to these standards implement them fully. The Fund should find ways of publicising failures to meet the standards, perhaps by detailing complaints on its Internet Bulletin Board and by publicly removing countries from the SDDS if they fail to remedy such failures. We recognise that this is a major investment for emerging market countries and call for technical assistance to be made available to assist them in their efforts.
- We also encourage the private sector to make full use of the SDDS as a source of information on economic and financial statistics, and as an indicator of the transparency and quality of national data, and to play their part in the ongoing effort to improve data standards.

In addition, it would be useful if countries were to provide more qualitative descriptive information on their financial systems, markets, institutions, laws and other aspects of the financial sector, incorporating details on banking supervision, bankruptcy procedures and the credit culture, skills and structure of banking sectors, including the relationship between banks and the government and industrial sector. We need to consider further, in conjunction with the IFIs, who should collect this information and how it should be published.

Openness in policymaking

More openness in national policymaking could have helped anticipate the crisis, and more generally helps to inform the market as well as promote public understanding and support for sound policies.

- In this context, we particularly welcome the IMF's Code of Good Practices on Fiscal Transparency. We also welcome the IMF's decision to examine the case for developing a similar code for financial and monetary policy. We think the code on fiscal transparency, and a further code on financial and monetary policy, would provide useful benchmarks for assessing the openness of policy making during Article IV consultations. We will also be encouraging the MDBs to promote the code.
- We encourage the IFIs to place more emphasis on governance issues and the openness of the policymaking process in their operations and surveillance work.

Openness at the International Financial Institutions

The IMF and the World Bank have traditionally communicated their concerns and recommendations for policy action in confidence. This avoids the risk of provoking an undue market reaction and gives countries the opportunity to take action on their own account. However, we think there is a case for greater openness at the Fund and the World Bank, as well as for encouraging members to comply with the standards they and others set and the advice they provide.

It is important for the IMF and the World Bank to publish information on member countries on a regular basis to help investors take better informed decisions. The World Bank and the MDBs have made substantial progress on this front over a period of years. The IMF has also taken steps to provide more information in recent years. In particular the introduction of Press Information Notices (PINS) last year was an important step forward in enhancing transparency. These enable members to release the conclusions of IMF Article IV consultations, if they choose to do so.

- We need to consider how to build on recent work by the IMF to increase its openness. Options include working towards timely and systematic publication of PINS for all Article IV consultations, publication of letters of intent and policy framework papers, and including more country detail in the IMF's World Economic Outlook. It is also important for the IMF and the

World Bank to consider building incentives for countries to publish such information, for example in programme design.

- At the World Bank, we believe further serious consideration should be given to developing a policy with regard to Country Assistance Strategies aimed at increasing their disclosure.
- There should be further consideration of the possibility of the IMF developing a mechanism of 'tiered responses' to communicate with the Board and with countries when advice is ignored. In addition, it may be helpful for the Fund to make public statements of concern about its assessment of countries' policymaking and vulnerabilities.
- We also encourage the IMF and the World Bank to consider ways of doing more to explain their policies and processes in public, in order to promote better understanding of their role in the global economy. We welcome the steps the IMF has taken to arrange external evaluations of some of its activities. We encourage it to explore ways of making this external evaluation more systematic.

Helping Countries Prepare for Global Capital Flows

International capital flows enable a better global allocation of capital and foster economic development. However, events in Asia have shown that weaknesses can suddenly be exposed by global capital markets, making countries with weak fundamentals, including weak financial systems, more vulnerable to external shocks. They have also highlighted the dangers of poorly sequenced and unbalanced liberalisation.

- To ensure that the process of capital account liberalisation is orderly, it is important that sound macroeconomic policies and supervisory and regulatory practices are put in place. Correct management of the liberalisation process is crucial. And the process needs to be accompanied by reforms to strengthen the domestic financial system.
- The IMF has and should have an important role

to play in this area, providing advice on how best to manage orderly capital account liberalisation and monitoring countries' vulnerability to capital flows.

- We support measures to improve the IMF's capital markets expertise, and to collect more information on levels of external debt as part of its regular surveillance work. In doing this, the Fund should collaborate with the World Bank, BIS and OECD.
- We urge the IMF and other fora to examine how to monitor effectively capital flows, including short-term capital flows, with a view to providing information to the market and promoting stability.

Capital account liberalisation should not be confused with open access to domestic markets for foreign firms.

- Open access to domestic markets for foreign firms can help with the development of the deep and liquid domestic financial markets, with soundly managed and well capitalised firms, that are needed to help improve the conditions for liberalising capital flows.

Strengthening National Financial Systems and Corporate Governance

Weaknesses in the financial sectors in some Asian countries increased their vulnerability to external shocks. These weaknesses included over-extended lending to the property sector, the build up of large off-balance sheet positions, excessive exposure to highly leveraged borrowers, policy-directed loans and excessive reliance on short-term borrowing in foreign currency. Had information about these developments been more widely available earlier, the international markets and IFIs might have been better placed to assess the risks in Asia and elsewhere. The crisis also highlighted weaknesses in risk assessment in our own financial sectors. Some institutions paid inadequate attention to risks. There is therefore a need for strengthened mechanisms to ensure appropriate risk analysis. This points to the need for enhanced international surveillance and improved prudential standards, and

to encourage internationally active financial institutions to act prudently on available information.

- Supervisors, co-operating at Basle and elsewhere, should work to encourage private sector financial institutions to adopt better systems for country risk assessment.
- We need to continue to improve the supervision of large internationally active financial groups. A separate G7 report on financial stability addresses the need to improve cooperation and information sharing between national supervisors on the activities of such groups.
- Supervisors and regulators should consider how best to encourage individual banks and their supervisors to monitor the adequacy of foreign currency liquidity (maturity of liabilities in relation to assets) separately from domestic currency liquidity.

A primary need is to encourage countries to strengthen their own financial systems, to ensure that banks and other financial intermediaries have the information, skills and corporate incentives to take well founded credit and risk decisions, and are properly supervised and regulated; that corporate and financial sectors follow good accounting, disclosure and auditing practices; and to promote deeper, more transparent and more open local bond and equity markets that will provide alternative sources of finance to short-term foreign-currency bank borrowing.

- In addition to the Core Principles for Effective Banking Supervision, we also need to develop internationally accepted principles for auditing, accounting and disclosure in the corporate sector, together with arrangements for ensuring that these principles are put into practice.
- We also welcome the OECD's initiative to develop standards and guidelines on corporate governance, and to report by spring 1999.

Strong efforts are needed to ensure that sound and transparent standards are implemented. While this is primarily a matter for the national authorities concerned, incentives need to be put in place that will help deliver this. The primary incentive is the

need for emerging markets to maintain confidence in order to access capital markets. In addition:

- The Fund has taken steps to sharpen the focus of its surveillance of the financial sector, for example during Article IV consultations. We encourage the Fund to build on this in collaboration with the supervisors, and to promote the Basle Committee Core Principles for Effective Banking Supervision. Similarly we encourage the World Bank to strengthen its reviews of countries' financial sector policies and corporate governance, and highlight these issues in its Country Assistance Strategies.
- Further consideration should be given to how incentives to adopt – within a reasonable period of time – the Core Principles could be strengthened, for example by making access by foreign financial institutions to major financial centres conditional in part on the implementation of adequate prudential and regulatory standards in their home countries.
- We encourage the World Bank and regional development banks to help foster transparent markets that are open to all well founded financial institutions, skilled management, independent banks able to make professional credit and risk decisions, and market structures that support these objectives.

There is a gap in the current international system with respect to surveillance of countries' financial supervisory and regulatory systems. Enhanced surveillance in this area would help encourage national authorities to meet international standards and help reduce financial risk. Such assessments of supervision and regulation can lay the groundwork for policy discussions and appropriate assistance, where needed, from the IMF and MDBs for programmes to strengthen financial systems. We need to address how best to organise international work in this and related areas. A number of international institutions are involved in various aspects of policy advice in the regulation of national financial systems. Their functions include assistance at times of financial crisis, long-term systems building and regular surveillance. There is a case for considering how to co-ordinate this work more effectively.

- The IFIs and international regulatory bodies have an important role to play in providing technical assistance and advice to emerging markets on strengthening and restructuring financial systems. The World Bank has enhanced its capacity to provide advice on financial sector development, through the establishment of the Special Financial Operations Unit (SFOU) to provide assistance to crisis countries. Also the Basle Committee and the BIS have established an Institute for Financial Stability at Basle.
- We see an urgent need for a system of multilateral surveillance of national financial, supervisory and regulatory systems. This could encompass surveillance of such areas as banking and securities supervision, corporate governance, accounting and disclosure, and bankruptcy. We are considering ways, and ask the relevant institutions to develop proposals on ways, in which greater cooperation can be achieved including options for institutional reform. In any event, this will require greater cooperation and improved relations among all these institutions, and drawing on national regulatory expertise. We will review progress on this important area by the autumn.

Burden Sharing by the Private Sector and Moral Hazard

The global economy needs private sector financial institutions that take risks on the basis of careful assessment. If such institutions believe that the entities to which they lend will be bailed out, they have no incentive to make a proper risk assessment. It is therefore important to ensure that the private sector takes responsibility for its own lending decisions. We also need approaches to ensure that the private sector is involved in crisis resolution, and bears the costs as well as the rewards of its lending decisions.

There will always be pressure in the event of a crisis to act quickly to stabilise the situation. We need to find ways in which this can be done without implicitly insuring debts to the private sector. It would be highly desirable to create in advance a framework for handling debt arrears to make it clear that all exposed institutions in the private sector will bear some costs.

- National policy should focus on creating the right incentives: by introducing effective bankruptcy laws; by making explicit and establishing financially viable deposit insurance schemes; and by ensuring that lender of last resort assistance in domestic currency is provided for illiquid institutions only when there is real systemic risk. These measures, along with improved prudential supervision, will help send the appropriate signals to the private sector.
- The IMF should signal that in the event of crisis it will be prepared to consider lending to countries that are in arrears, including in situations where debt standstills have arisen, if the debtor country adopts appropriate adjustment policies.

There needs to be a framework for ensuring continuing private sector involvement when a country, or its financial or corporate sector, is facing difficulties in meeting its foreign currency liabilities as they fall due.

- We need further discussion with other countries and the private sector on how best to establish such a framework.
- In particular we should consider ways of giving effect to the G10 recommendations on flexible forms of debt agreements.

IFI Resources and Financing

The response of the IMF and World Bank to the Asian crisis has confirmed their role at the centre of the international financial system. The Asian Development Bank has also played a crucial part in responding to the crisis. However, this has involved an unprecedented level of new commitments for the IMF and other IFIs. We need to address the increased demand on resources:

- To enable the IMF to play its central role in the international monetary system, it is essential to implement from January 1999 the increase in quotas as agreed under the IMF's recent

Quota Review in order to ensure the IMF has sufficient usable resources. It is also essential to bring the New Arrangements to Borrow (NAB) into effect as soon as possible. We welcome the creation of the Supplemental Reserve Facility (SRF).

The Asian crisis also demonstrated that in special circumstances bilateral financing can provide a source of additional financing for balance of payments:

- It will be important to ensure that bilateral financing is developed in conjunction with the IMF, is consistent with the IMF response and does not undermine IMF conditionality.

We have suggested a number of ways to enhance the role of the IMF and the World Bank.

- It will be important to consider whether the distribution of staff and resources needs to be adjusted to address the new priorities.
- Closer cooperation between the Bank and Fund will be particularly important to avoid overlap and to maximise use of expertise.

Strengthening Global Dialogue

These issues and our response to them have demonstrated the need for a more intensive global dialogue on developments in the global financial system between industrial and emerging market countries and countries in transition. We have had useful discussions over the last few months, in the lead up to the Birmingham summit. We would like this report to be seen as a contribution to the debate on the lessons of the Asian crisis, and we will continue to consult widely as we develop our thinking.

- Further thought is needed on how the existing global fora for discussion of such issues, in particular the IMF Interim Committee, could be developed to permit a deeper and more effective dialogue.