Crisis prevention and the role of IMF conditionality

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(*) Opinions expressed are the author's and do not commit Banca d'Italia.

I. <u>Prevention</u>

The issue of crisis prevention has come powerfully to the fore owing primarily to two aspects of the experience of financial distress of the late nineties. First, the massive resort to official financing to cope with an emergency in one or more large countries and to design a rescue package raises the question of the adequacy of official reserves in globalized markets. Second, the willingness of the international community to shoulder the burden of intervention aimed at managing crises that in many cases are triggered by structural distortions or economic policy errors accentuates moral hazard for debtors and creditors alike - so much so that it becomes politically unacceptable. The risk is that of fuelling mismanagement by governments that resort to foreign credit and of fostering superficial evaluations of creditworthiness by markets and intermediaries that provide finance.

Traditionally, IMF intervention in support of a country suffering from a balance-of-payments crisis has been accompanied by conditionality; that is, the actual disbursement of funds in successive tranches has been made conditional upon the country's implementing an economic programme to restore a sustainable macroeconomic equilibrium.[1]

The crises of the nineties were marked by a complexity not to be found in the experiences of the preceding decades. There was no lack of traditional macroeconomic imbalances, which tended to concentrate in the external accounts, but these were exacerbated by severe disequilibria in banking and financial systems, bankruptcies and inefficiency in vast sectors of the corporate system, and inadequacies in the sphere of prudential controls and disclosure requirements.

Hence, the scope of conditionality had to be extended beyond macroeconomic policy to embrace microeconomic measures, markets' operating rules and prudential supervision. This strengthens and even gives pre-eminence to what we might call "ex ante conditionality", i.e. the set of preventive measures aimed at minimizing the risk of a crisis erupting.

The strategy of prevention thus requires the involvement of a plurality of actors, with appropriate forms of coordination.

An overhaul of the functions of the IMF has been for some time a prominent topic of debate among scholars and policymakers.[2] However, the Fund's central role in supervising the

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[1] B. Eichengreen, *Toward a New International Financial Architecture*, Institute for International Economics, Washington D.C., 1999.

[2] See L. Summers, "The Right Kind of IMF for a Stable Global Financial System", speech delivered at the London Business School on 14 December 1999, in *U.S. Treasury News*, December 1999; S. Fischer, "On the Need for an International Lender of Last Resort", speech to the American Economic and Finance Association, New York, January 1999, and "Presentation to the International Financial Institutions Advisory Commission", February 2000, in *IMF Speeches (1999-2000); Meltzer Commission Report*, US International Financial Institutions Advisory Commission, US Congress, March 2000.

international monetary and financial system and facilitating cooperation among member countries does not appear to be in question.

The battery of intergovernmental groups working for international economic cooperation has been enhanced of late, particularly with the addition of organizations concerned with prevention . Since 1999 the Group of 20 and the Financial Stability Forum have been operating alongside older formations (G7, G10, etc.). The political value added of these groups consists in the direct involvement of important emerging-market countries in defining best practices and rules of conduct that, when applied at the national level, will no longer be viewed as imposed from the outside but as the fruit of common understanding. It can be argued that the ranks of countries participating in new forms of international rule-making are growing.

Central banks and supervisory authorities are increasing their contribution to the prevention process, particularly by drawing up guidelines for strengthening the stability of banking and financial systems that national authorities are encouraged to apply.

It is now the consensus view that the adoption of disclosure standards, best practices and codes of conduct in the economic and financial field is necessary, although certainly not sufficient, to ensure financial stability at the international level. In some areas, such as accounting and auditing standards, the private sector can play and in fact has played a significant role. But acknowledging that role does not imply any lessening in the importance of the function of multilateral institutions, the IMF first and foremost; only the Fund has the power to legitimate the standards drafted by private organizations and to verify that they are actually observed.

The ability of the IMF to enforce the traditional macroeconomic policy conditions on countries requesting financial assistance outstrips its capacity to enforce what we have called ex-ante conditionality. The reasons for this are evident. Compliance with traditional macroeconomic conditions is easily verified: ordinarily these are translated into monetary, exchange rate and fiscal policy measures destined to restore a sustainable internal and external balance. Above all, a country's determination to fulfil the conditions is stiffened by the link with the Fund's financial assistance.

But when a country is not under the gun of a crisis, what will prompt in to alter certain aspects of its economic policy along the lines that the IMF may have suggested in the course of its normal monitoring of member countries' economies? How to verify not so much the introduction of banking regulations, which is simple enough, but their actual application? How to be certain that the information made public, for example on the balance sheets of banks and non-financial firms, is complete and accurate?

A greater diversity of the forms of conditionality (macroeconomic, institutional, ex-post and ex-ante rules) and an effective system of incentives and penalties must be flanked by an appropriate configuration of the procedures for applying and checking compliance with those forms of conditionality. It is possible to envision a constellation of forces ranging from political pressure by various intergovernmental groupings to "educational" action on the part of the central banks and supervisors, to oversight and self-regulation of the markets, all the more effective the less they are exposed to moral hazard.

II. The debate on conditionality and its structural components

Conditionality is indeed at the heart of the catalytic role of Fund programs. It is the combination of a credible adjustment program and official financing that allows members to regain access to capital markets following a crisis and in due course reduces the need for official support. Official financing is necessary to restore market confidence but alone would not do the job; it could even be counterproductive if it provided private investors with the necessary resources to flee for the exits, running away from the crisis-stricken country virtually unscathed. Conditionality, when designed in a credible and effective manner, is also essential to the success of the strategy being devised by the international community to involve the private sector in managing sovereign financial crises. Concrete results on this matter have been lacking so far, but some progress has been made in identifying the chief ingredients of a solution, namely a combination of firm ex ante limits to official financing and the possibility for debtor countries to resort to standstills, i.e. suspend debt-service payments if confronted with a crisis, with the approval of the international community.

If the IMF continues to be involved in both crisis prevention and crisis management, then conditionality, including so-called structural conditionality, will continue to be a necessary instrument to regain credibility and access to capital markets. I am convinced that structural conditionality is not a capricious addition to the Fund policy tool-kit, but stems from the many challenges that the Fund has been required to address since the eighties. For example:

Traditional macroeconomic conditionality was deemed to be ineffective because the exclusive focus on short-run aggregate demand management neglected the structural causes of balance of payments problems and resulted in excessive hardship on borrowing countries through unduly contractionary fiscal and monetary policies. The argument gained further strength in light of the increasing involvement of the Fund in low income and transition countries where structural weaknesses were pervasive.

Aggregate demand management largely focuses on the quantity of adjustment, say a reduction of fiscal imbalances, often at the expense of the quality of adjustment, say the long-run sustainability of public finances. Domestical international investors, however, increasingly take a long-run view of the problem. Accordingly, they will be wary of supporting a program that is excessively biased toward short-run temporary measures and does not address the structural weaknesses in the economy, say in the fiscal or the financial sector. The Fund's catalytic role is thus likely to be_severely hampered if markets agents are not convinced about the sustainability of the adjustment effort.

Fund-supported programs have been repeatedly criticized for their failure to allow countries to graduate from Fund support. The inability to graduate from Fund support is often mentioned as evidence of the failure of conditionality. Structural conditionality helps address this criticism insofar as it contributes to a more permanent resolution of the factors that lie behind the balance of payments need.

In sum, long-run considerations are a critical component of Fund programs. They are intended to ensure that members are able to address the root causes of their external payments imbalances and thus reassure markets about the long run nature of the adjustment process. So-called structural conditions will be necessary insofar as they help achieve the objective of a sustained improvement in the balance of payments.

I turn now briefly to the question of structural reforms and the "core" areas of Fund activities. Reviews conducted at the Fund indicate that structural conditionality has largely been confined to "core" areas and that its composition has shifted from an emphasis on trade and exchange rate liberalization to institutional and financial sector reforms. This shift in turn reflects the increasing importance of financial sector issues in Fund programs and the fact that early programs have been_relatively successful in achieving progress in reforming the trade and exchange rate systems. In this respect, continuing reliance on Fund support is not necessarily an indication of program failure and addiction to official financing, but to some extent can be seen as a measure of the success of Fund programs, with countries moving along the ladder of structural reforms.

Finally, on the concept of ownership, there is one prominent and recurring argument in the debate, namely that the increased scope of conditionality, i.e. too many and too much detailed conditions spelled out in the programs, undermines program ownership and is largely responsible for the unsatisfactory record of program implementation. I am not fully convinced by this argument. First, as the Fund has documented in some of its recent studies, the implementation rate shows no negative correlation with the extent of structural conditionality. Second, the very concept of ownership is fairly elusive. Both theory and experience show that adjustment, and even more so structural reform, create both winners and losers. Ownership is not independent of the identity of the winners and losers and the way their conflicting interests are reconciled through the political process. The creation of a broad political consensus is key to the design and conduct of sound policies. In this endeavor, structural reforms can be of help: particularly when compared to restrictive macroeconomic policy, they may alleviate the distributional trade-offs by raising economic efficiency and strengthening growth prospects. Moreover, while individual reforms may exacerbate distributional conflicts, a broad-based reform program may both amplify the efficiency gains and generate a sufficiently large range of winners to muster political support. Overall, therefore, there is little or no reason to argue that an ambitious program of structural reforms would necessarily undermine program ownership and implementation. Clearly, the program must not be perceived as being imposed by an outside agency and the country must not delay its approach to the Fund for too long for the fear of being imposed too many conditions . In normal times, ownership can be created through a patient and gradual process that combines policy advice, technical assistance, and ultimately program conditionality together with financial support. During a crisis, however, there is less or no time to build political support and the need for prompt action will typically take priority over the desire to build a strong constituency in support of the program. In such situations, structural reforms might be essential to reassure markets as to the long-run sustainability of the adjustment effort.

III. The soft law approach [3]

In the design of reform of the international financial architecture the notion has taken prominence that the process should mostly rest on recommendations, guidelines, or other arrangements of a non-binding nature, internationally agreed but whose implementation would be in essence left to national authorities, with incentives such as "peer pressure" or "market discipline".

This strategy has been labeled "soft law approach", due to the fact that its content has neither the strength of ordinary law nor the weakness of international conventions. It was adopted by the official community in early 1999, with the establishment of the Financial Stability Forum (FSF). The FSF is a true novelty in the topography of international cooperation. Its mandate is to improve coordination and the exchange of information between the various authorities responsible for financial stability; besides, the FSF is entrusted with assessing vulnerabilities affecting the international financial system and identifying and overseeing action needed to address these vulnerabilities. The FSF composition is peculiar; it comprises representatives of Finance ministries, central banks, and regulatory agencies of a number of countries (the G7 plus Australia, the

[3] This section draws extensively on C. Giannini, *Broad in scope, soft in method, international cooperation and the quest for financial stability in emerging markets*, manuscript, Bank of Italy, 2001.

Netherlands, Hong Kong and Singapore), plus representatives of the international financial institutions, of the ECB and of the main regulatory groupings (such as the Basel Committee).

The soft law strategy hinging on the FSF is therefore, in essence, a decentralized process based on informal international understandings which are to be implemented at the level of domestic jurisdictions.[4] It has three fundamental components: standards, governance, and incentives.

The standards. The purpose of the FSF in this field is to collect, endorse, and disseminate the activity of standard-setting bodies so as to ensure a speedier and fuller compliance. The first act of the FSF has been the compilation of a comprehensive Compendium of Standards, comprising at present some 60 sets of standards relevant to international financial stability. Among these, the FSF has identified 12 sets of standards as key for sound financial systems and which therefore deserve priority implementation. These standards represent minimum requirements for good practice. They are all based on the assumption that the country possesses a predictable legal system, and dependable rules for political accountability.

The area of standard setting, however, does not exhaust the activities of the FSF. Under the "vulnerability" heading, the FSF has so far published three reports, respectively on highly leveraged institutions, capital flows, and offshore financial centers. For our purposes, the latter is of particular importance, because it represents the first attempt of the official community to come to grips with a major gap in the present regulatory setting, namely the existence of financial centers which derive their attractiveness to investors and financial intermediaries from having lower taxes and laxer regulatory requirements. The FSF report included a tripartite list of offshore centers, with individual centers being classified according to the quality of their regulatory framework. Not surprisingly, the publication of the list was met with considerable uproar.

Judging the quality of standards is no easy task, since the specificity and degree of precision of international standards may and does vary considerably. In general, they lack the precision required for legal enforceability. On the other hand it is important to have countries accept rather general principles. Moreover, it may be easier to have countries adopt international standards if they are flexible enough to be adapted to local legal traditions. This can be seen as but one aspect of the "legitimacy" problem. There are two dimensions to the problem. One is eminently technical. It is awkward to establish internationally accepted norms or minimum standards given the diversity of legal systems, traditions, regulatory set-ups in areas such as bank supervision, securities markets regulation, bankruptcy law, and systems of accounting and auditing. The second one is political. A

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[4] Mario Giovanoli, "A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting", M. Giovanoli (ed.), *International Monetary Law: Issues for the New Millennium*, Oxford University Press, Oxford, 2000.

sovereign state is asked to transpose into its legal practices norms and codes which emanate from forms of international cooperation in which the state may not participate at the cost, in case of refusal to conform, of being "punished" by the adverse appraisals and ratings in globalized markets.

Governance. For informal cooperation to work, prescriptions emanating from it must first of all be perceived as legitimate by their recipients. This calls for the inclusion of a large number and variety of countries beyond the original G-10 membership. On the other hand the fact is that informal processes, such as the Basel process or the soft law approach now being pursued, work out of consensus.

This concern notwithstanding, some expansion in the membership of the main fora was simply inevitable to increase the chances of success of the process. Through enlarged participation, the concern that a particular group of countries wanted to impose its own standards would be mitigated. Thus, the G7 took the initiative of setting up both the FSF and the Group of Twenty, a brand-new grouping comprising, besides the G7 itself, the main emerging market countries.

In my opinion, an appropriate set of arrangements could be as follows. Rule-making should remain the responsibility primarily of the specialized self-regulatory organizations: the Basle Committee for banks, IOSCO for securities markets, IAIS for the insurance industry, IASC for accounting standards. Effective rule enforcement should be the job of the governments that elect to incorporate the rules into their national legal systems. Between these two moments, international institutions have a key role to play, the IMF in particular. It can exert strong pressure on countries if the rules and standards agreed are embodied in specific recommendations endorsed by the Fund, because this would give the rules a political legitimacy they now lack insofar as they are the product of bodies whose membership was restricted to the most highly developed countries. The Fund could also make observance of some standards an essential element of conditionality; that is, it could link the granting of credit to action on financial structures, markets and corporate governance. Even when no outlay of financial resources is at issue, the Fund could make judgement of observance of international standards part of its ordinary oversight activity. In and of themselves such public judgements, which are the object of the observance reports already being drafted on an experimental basis, can exert effective market discipline. In the end the financial markets would presumably punish countries that failed to observe certain minimum standards, lowering their ratings, increasing risk premia and hence making credit more costly.

The national supervisory authorities, finally, could supplement such action by making the IMF's judgement on effective observance of the standards a factor in determining (under the Basle

Capital Accord) the capital ratios on lending to a country or in allowing access of foreign intermediaries to their own markets.

Incentives. Standards do not have a legal character, being mere recommendations of international bodies. Working through incentives is therefore crucial to ensure their adoption. In principle, there exist two different sets of incentives for countries to adopt standards: those that flow indirectly from market reactions to lack of observance; and those that result directly from the actions of the official community. In a market-led global economy with decentralized governance, one would expect the first set to provide the stronger mechanism. However, the surveys conducted by the FSF Task Force on Incentives to Foster Implementation of Standard appeared often to be unfamiliar with many of the existing standards. When they familiar, they declared to place other considerations, such as political risk and economic fundamentals, above the regulatory/supervisory setup.

Official incentives may be grouped into two categories: "peer pressure" and "financial incentives". Peer pressure is the traditional mechanism through which the Basel process works. More recently, a tougher attitude has prevailed in relation to countries or financial centers that do not conform to internationally accepted codes of good behavior. Three notable examples are the publication by the Financial Action Task Force instituted by the G7 to combat money laundering of a list of jurisdictions, graded according to their degree of willingness to cooperate with international authorities concerned about money laundering, the OECD's list of jurisdictions considered to be tax havens, and the FSF's initiative concerning offshore financial centers. These initiatives, however, are too recent to assess whether they could be sustained in the medium to long run so as to yield the fruits they are intended to.

As to "financial incentives", the most obvious is the inclusion of the observance of regulatory and supervisory standards in IMF conditionality. This is something the IMF to a certain extent already does as recalled in Section II. From the most recent review conducted by the IMF staff, it turns out the about a quarter of structural conditions pertain to the financial system.[5] There are two problems with IMF conditionality. First, it can be expected to be effective only if countries need IMF resources, namely if they do borrow. Second, in recent years, the IMF has been subjected to heavy pressure from outside to reduce the scope and weight of structural conditionality in its programs. Here, the arguments developed in Section II apply.

[5] International Monetary Fund, *International Capital Markets*, April 2001.