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## **" COMMENTARY ON THE FINANCIAL STABILITY FORUM'S REPORT OF THE WORKING GROUP ON CAPITAL FLOWS "**

**Background Paper for Special Session IV on Global Financial Issues\***

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**COMMENTARY ON THE FINANCIAL STABILITY  
FORUM'S REPORT OF THE WORKING GROUP  
ON CAPITAL FLOWS**

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## ***Abstract***

*This Report consists principally of recommendations and guidelines. It acknowledges the threat to the benefits of a liberal global regime for international capital flows posed by their instability. Concern is expressed as to risks to stability linked to reliance on short-term borrowing from banks, the interaction between different financial risks, and faultlines in global financial markets resulting from firms' own hedging and risk management that may be difficult to identify in advance. But, in general, the Report's recommendations focus mainly on changes in recipient countries in practices with regard to the monitoring and management of financial risks, rather than on changes in the main sources of international lending and investment. Those directed at the latter would require no major deviations from the thrust of existing policies in the countries concerned. In particular, the Report does not discuss proposals put forward in some quarters for substantial improvements in transparency regarding operations in currency markets widely considered to have contributed to recent episodes of instability. On the subject of controls over capital movements, the Report limits itself to cautious endorsement of those over inflows.*

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# **COMMENTARY ON THE FINANCIAL STABILITY FORUM'S REPORT OF THE WORKING GROUP ON CAPITAL FLOWS\***

**Andrew Cornford**

## **Introduction**

The *Report of the Financial Stability Forum's Working Group on Capital Flows* (henceforth the Report) consists principally of a long and carefully annotated set of recommendations and guidelines. It begins by acknowledging the threat to the benefits of a liberal global regime for international capital flows posed by their instability. The Report is concerned with risks to stability linked to short-term borrowing, and its recommendations under this heading include a change at the level of the sources of capital flows in the form of removal in the revised Basle Capital Accord of the incentive to short-term bank lending in the 1988 Accord. But in general the Report's recommendations focus mainly on changes in recipient countries in practices with regard to the monitoring and management of financial risks rather than changes in the main sources of international lending and investment. Those directed at the latter would require no major deviations from the thrust of existing policies in the countries concerned. In particular, the Report fails to dismiss proposals recently put forward in some quarters for substantial improvements in transparency regarding operations in currency markets widely considered to have contributed to recent episodes of instability. The subject of controls over capital movements is broached but the Report limits itself to capital inflows, and the case for these is somewhat cautiously accepted.

## **I. THE WORKING GROUP'S MANDATE AND THE REPORT'S PRINCIPAL FOCUS**

To some extent the focus of the Report can be explained through the Working Group's terms of reference. These were as follows: (i) to evaluate prudential policies, regulations and risk-management practices in borrowing countries that may help to reduce systemic risks associated with the build-up of external indebtedness; (ii) to identify regulatory and other factors responsible for an unwarranted bias in favour of (i.e. incentives to) short-term flows, and to recommend offsetting actions; (iii) to review progress in improving the adequacy and timeliness of data and reporting systems needed for monitoring the risks associated with capital flows, and to indicate areas for improvement; and (iv) to evaluate other potential measures in both debtor and creditor countries to reduce the volatility of capital flows and its adverse consequences for systemic stability.

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\* The author is grateful to Dr. Aziz Ali Mohammed for providing the inspiration for the writing of this paper, though he should not be held responsible for the result.

Although the mandate under (iv) is open-ended, these terms of reference help to explain the report's focus on transparency, risk monitoring and management, and bank supervision, and its primary concern with practices in borrowing countries. Indeed, the Report acknowledges that the Working Group considered beyond its scope the framework of macroeconomic policy, aspects of the legal infrastructure such as the law of contracts and insolvency, and highly leveraged institutions and offshore financial centres (both of which subjects are covered in other reports of the Financial Stability Forum). Some implications of this focus, in particular the consequent omission or downplaying of important topics, will be taken up in the commentary which follows.

## **II. THE REPORT'S PERCEPTION OF RECENT EXPERIENCE**

In section II concerning the nature of the problem, after noting the considerable variation in the levels of development of their financial systems among countries receiving foreign private capital, the Report declares that it is principally concerned with those "with relatively small but open financial markets", a description which would include most of the recipients of substantial amounts of such capital which have been directly involved in, or the subject of special attention during, recent international financial crises. The features of recent experience singled out by the Report are primarily, as one might expect, those with a connection to its recommendations. Most of these features now figure in a standard way in accounts of this experience, and include the vulnerability of countries with large accumulations of short-term debt owing to the associated liquidity and roll-over risks, similar dangers associated with certain categories of portfolio investment, economic actors' inadequate risk management, and policies in both source and recipient countries which are conducive to the accumulation of short-term or volatile capital inflows.

The incentives to short-term capital flows in provisions of the 1988 Basle Capital Accord have already been mentioned, and an appendix to the Report gives further instances of policies involving such incentives in recipient countries. In the Republic of Korea, for example, according to the Report, the cautious liberalization of capital transactions of the 1990s led, in practice, to a bias in favour of short-term borrowing by banks owing to continuing tighter control over direct borrowing by corporations and continuing "window guidance" applied by the Bank of Korea to medium- and long-term borrowing by banks. In Thailand the establishment of the Bangkok International Banking Facility (BIBF) in 1992 and of the Provincial International Banking Facility (PIBF) in 1995 served as an encouragement to short-term bank borrowing owing to the exemption from controls of certain transactions such as overdrafts and liabilities from currency trade, international trade financing, and non-resident deposits at BIBF banks. In Indonesia restrictions on banks' foreign borrowing in the period preceding the financial crisis excluded short-term trade financing and borrowing for certain other purposes such as by private companies to finance private projects unrelated to public entities as well as borrowing required for certain operations in money and capital markets. The Report also notes that differential regulatory ratios (such as those for reserve and liquid-asset requirements) favouring foreign-currency and non-resident deposits in some countries have provided an obvious incentive to short-term foreign borrowing. Various techniques involving the provision to foreign lenders of exchange-rate guarantees are also cited as having contributed to the accumulation of foreign borrowing (and not only at short maturities), including the dollar-indexing of government debt, forward cover by the central bank for authorized short-term external borrowing by banks, and (as part of sterilization operations) the availability through the central bank of foreign-exchange swaps at a forward rate

close to the spot rate (an important feature of pre-crisis policy in Thailand). The appendix also mentions various other policies connected to the maintenance of stable exchange rates and the sterilization of capital inflows which are conducive to borrowing driven by international interest-rate arbitrage.

One of the outcomes of recent financial crises has been increased attention to stocks of external and foreign-currency assets and liabilities. As the Report puts it (para. 29): “while a typical manifestation of an external crisis is a reversal of capital *flows*, the risks that give rise to the crisis often lie in the structure of the *stocks* of external or foreign currency assets and liabilities that have accumulated over time”. Implicit in this recognition of the importance of such stock data for policy towards capital movements is the need to address shortcomings of existing systems of financial reporting. The Report refers (paras. 25–26) to some of the problems under this heading: for example, it acknowledges the pressures on external payments which can result from the adjustment of derivative positions which are off-balance-sheet and not always adequately covered by accounting rules and which, even if disclosed, are capable of blurring distinctions between different categories of exposure (such as those between short and longer term). But, as explained further below, neither in its identification of problems posed by the current regime for international capital movements nor in its policy recommendations does the Report fully address issues that have been raised by a number of developing countries concerning the opaque nature of positions and operations of financial and non-financial firms which can be a source of unpredictable pressures in currency markets.

The Report follows various recent commentary on instability in international financial markets in acknowledging that hedging and other practices make many of the system’s fault lines difficult to identify in advance.<sup>1</sup> As the Report puts it:

Certain commonly employed risk management techniques ... can have the effect of adding to the volatility of both prices and flows in the international capital market ... That is, investors acquire or dispose of claims whose risk characteristics and price history resemble those of the asset being proxied but where the market is deeper, more liquid, or subject to fewer restrictions and controls. Such behaviour was one of the factors behind the large fluctuations in capital flows to South Africa and several countries in Eastern Europe around the time of the Asian crisis.

In the context of more recent events attention has also been drawn (though this example is not cited in the Report) to the way in which Brazilian bonds have become an instrument widely used

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<sup>1</sup> The reasons for these difficulties are spelt out at some length in CGFS (1999: 15) – which relied partly on interviews with market participants in a number of financial centres – as follows: “By their nature, some ... market risk control tools have the potential to tighten links across markets and to alter price dynamics. As one example, the strategy termed proxy hedging led traders to use major national markets to offset positions in thin markets that might have been difficult to liquidate quickly. Complaints about such practices surfaced regarding asset prices in Australia and Hong Kong at the time that the Asia crisis broke in 1997. When considering the events of August and September 1998, market participants reported that as financial conditions in Russia deteriorated, short positions in both Hungarian and Brazilian debt, which offer relatively deep markets, were put in place to hedge against long positions in Russian securities. Even mature markets were not immune. In European markets, a broad range of assets was hedged by the highly liquid bund futures contract, triggering market pressures when spreads between these securities and bunds widened. ... In particular, as decisions on exposure limits shifted toward senior managers as stresses mounted, losses in one market, because they reduced the overall amount of capital, then prompted withdrawals from other markets. In that sense, the events of last fall mimicked those of a traditional margin call, albeit on a worldwide scale, as positions in a variety of markets were unloaded as a result of losses originally concentrated in a few.”

by investors in emerging markets to hedge positions in the debt of other countries such as Morocco, Republic of Korea and Russian Federation (Buckley, 1999: 188–189).

A better idea of the nature of the fault lines of the international financial system will no doubt be acquired as transparency is improved along the lines indicated in the Report. And the risk-management practices recommended in the Report should be capable of reducing the dangers associated with these fault lines, hidden or not. But the Report avoids acknowledging in its observations on recent experience that the problems it identifies in the functioning of the existing regime for international capital flows are integrally linked to the way in which the goal of financial liberalization has been pursued since the 1960s by the governments of major industrial countries, multilateral financial institutions, and private economic actors, with only limited regard for the problems which result from the lack of an adequate framework of policy control.

A fundamental tenet since the 1970s of the policy of major developed countries regarding the external financing of developing and, more recently, transition economies has been promotion of a greatly expanded role for private sources. Yet, aside from some initiatives aimed at improving control of credit risk at the level of individual lending institutions, in countries which are the source of this financing only limited attempts have been made to address features of their lenders' and investors' behaviour which are capable of posing threats not only to the financial stability of these economies but also to that of international financial markets more generally. At the same time developing countries have been caught up in the associated pressures to liberalize the access of foreign capital, and policies adopted in response to these pressures, though often initially approved by official circles abroad as well as external investors, have frequently proved eventually to be ill-conceived and have contributed on occasion to financial crises. Yet despite this recent experience, many of whose adverse effects have been felt most strongly in recipient developing countries, the international debate on measures for solving or alleviating the problems of the regime continues to be dominated by countries responsible for its existing shape whose agenda for reform is strongly influenced by a determination to minimize any resulting constraints on their own firms.

The Report's failure to escape such a characterization can be linked to the limitations of its terms of reference (described in section I above). These exclude macroeconomic issues and policies except those with an immediate connection to the management of foreign exchange reserves and to certain aspects of external assets and liabilities. A particularly notable omission from the Report's assessment of the nature of the problem, which results from this limitation of its terms of reference, is any discussion of the influence of global macroeconomic conditions on the scale and direction of capital movements to emerging financial markets. The ebb and flow of such movements is often largely supply-driven, in particular being strongly affected by monetary conditions and the liquidity position of mutual funds in the United States. This was particularly evident, for example, in the influx of capital to Latin America during the period of monetary ease in the early 1990s, which then contracted in response to the tighter conditions of 1994–1995 and recovered again sharply thereafter. The Report's remit did not include macroeconomic surveillance, but the absence of any discussion of global conditions gives its observations on the nature of the problem a one-sided air.



### III. MONITORING AND MANAGING RISK

Section III of the Report (“Monitoring and managing risk”) contains the key recommendations. These are broken down between recommendations directed at the public sector, recommendations directed at the banking sector (regulators and supervisors as well as firms), and recommendations directed at the non-bank and corporate sectors. Capital controls are also covered in section III as a category of prudential measures. The remaining sections of the Report are largely subsidiary to section III. Section V concerns improvements in the data on external financial positions required for carrying out the recommendations on monitoring and managing risk, and section IV the building of institutional capacity needed for the same purpose. Under the latter heading is included the development of domestic securities markets, which is considered to have an important role in enabling better management of financial risks.

At the core of section III’s approach is the country’s external balance sheet. The Report argues that a detailed profile of this balance sheet is essential to monitoring and managing a country’s exposure to risk. This profile should make it possible to identify significant exposures to risk linked to different aspects of a country’s external financial position (currency risks, liquidity risks, etc.). The sectoral breakdown of this national balance sheet would be decided with this objective in mind, as well as with that of identifying linkages among sectors capable of facilitating transfers between them of risk exposures. The sectoral breakdown would thus need to include the public and private sectors and, within the latter, the financial and the non-financial corporate, and possibly the household sectors.

As noted in section II above, the focus on the elements of national balance sheets in the Report accords with the conclusions of much commentary on the lessons of the Asian crisis. However, whilst the importance of balance-sheet data to risk monitoring and management is incontrovertible, the question still arises as to how much can be expected from this front. Improvements in the quality and frequency of financial reporting have made possible better evaluation of financial risks at the firm level by lenders and investors (and have probably also frequently been associated with better internal control of such risks by firms themselves). But there have been limits to what such improvements have been able to achieve at the microeconomic level, and similar limits may also be expected to come into play at the macroeconomic level. The limits are linked to both the periodicity and quality of the data used in putting together a profile of the national balance sheet.

The Report (para. 42) says that its recommendations do “not warrant fundamentally new data collection mechanisms” but rather “better use ... of data that are being collected for different purposes, such as data disseminated to meet disclosure standards for firms whose assets are publicly traded”. In most countries there is undeniably scope for considerable improvements in standards of accounting and financial reporting, as well in the use by the authorities of reports containing data bearing on financial risk received or available from various different sources.<sup>2</sup> But such improvements cannot eliminate problems due to the speed with which assets, liabilities and off-balance-sheet positions can now be transformed, and to intrinsic limits to the extent to which risk exposure can be inferred from entities’ financial reports, in view of the latitude for obfuscation in existing accounting rules and lags in updating these rules to cover innovations in financial firms’ practices. Exposures through the interbank market or otherwise within the

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<sup>2</sup> For a survey of banks’ financial reporting and of their returns to central banks or financial regulators in 23 (mainly industrial) countries in the early 1990s see Cornford (1999).

financial sector are often cited to illustrate this point. Segmental reporting,<sup>3</sup> for example, might have made it possible to identify the scale of banks' direct exposure to the Russian Federation in 1998. But an entity's total exposure to the country might also have included indirect exposures to other financial firms with direct exposure,<sup>4</sup> in some cases in off-balance-sheet forms not to be easily inferred or quantified from available financial reports.

Unsurprisingly awareness of these limitations is expressed in the Report as follows: "Taking snapshots of the national and key sectoral financial balance sheets of an economy can potentially provide an important input to country risk assessments. But such balance sheets would not of themselves provide all the information needed to assess sensitivity to shocks" (para. 43). Thus the Report advocates the use of stress-testing and scenario analysis<sup>5</sup> to supplement monitoring national balance sheets. Such testing has an analogue at the firm level. Here, as part of prudential regulation, increased emphasis is now put on stress-testing by financial firms to offset the deficiencies of existing techniques for measuring market and credit risk for purposes such as internal control and setting capital requirements that result from reliance on historical data which may not include large enough shocks or discontinuities. But stress-testing at national level is considerably more difficult than at that of the firm as the Report acknowledges that "The information needed for stress-testing is not now available ... and methodologies for stress testing would need to be further developed" (para. 43). As part of the response to the difficulty of monitoring and managing risk through data on national balance sheets one might have expected here a reference to the need for the authorities to develop or maintain good sources of market intelligence<sup>6</sup> and for a more forceful approach to requiring information on position-taking in currency markets and on the offshore activities of financial firms which may pose a threat to financial stability (a subject partly addressed in section V of the Report, as discussed below).

The rest of section III flashes out in sectoral detail the implications of the Report's focus on the management of risk in different components of the country's national balance sheet. The principal focus is on institutions in borrowing countries (in accordance with the Working Group's mandate), but many of the recommendations, particularly those concerning risk management by private entities, could just as well contribute to a more stable system for capital flows through their application in creditor countries.

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<sup>3</sup> Segmental reporting denotes reporting of turnover and other results and of assets and liabilities by class of business and geographical area.

<sup>4</sup> An instructive example of the problems caused by indirect exposure to the Russian Federation during the 1998 crisis is provided by the High-Risk Opportunities fund (HRO), part of a family of funds called III Offshore Advisors. HRO had hedged the currency risk of its exposure in the market for Russian GKO's (short-term government debt instruments) with a number of major banks which had hedged their exposure in the Russian domestic market. However, after the Russian Federation's declaration of a moratorium on selected external obligations, these banks were unable to realize the monies due to them on their Russian hedges, and in turn reneged on their obligations to HRO, which was forced into liquidation (Dunbar, 2000: 201–202).

<sup>5</sup> Stress-testing and scenario analysis refer to techniques used to identify and estimate the effects of extreme events, such as major adverse shocks to the balance of payments (in the case of a country) or large losses due, for example, to stock-market crashes (in the case of financial firms).

<sup>6</sup> Market intelligence would appear to be an important part of the basis of allegations by certain Asian countries concerning the recent contribution of hedge funds to instability in currency and certain other financial markets. See, for example, Yam (1998) and RBA (1999a, paras. 11–13).

### **A. Public sector**

The Report is of the view that the traditional focus of debt management by the public sector has been too narrow and that the public, like the private, sector requires an “integrated debt and asset management strategy” (para. 47). For this purpose it should adopt several of the techniques of risk management deployed by, or advocated for the use of, the private sector, while also giving careful attention to the many ways in which its financial management interacts with that of the private sector and affects economy-wide risks. Under the public sector’s risk and liquidity management, the Report takes up many of the subjects traditionally often raised elsewhere under different headings such as the exchange-rate regime and reserve policy, the identification of possible sources of macroeconomic shocks, and the extent of the sector’s willingness to assume private-sector financial risks through such facilities as the provision of forward exchange cover. Under the public sector’s role in the reduction or hedging of risks in the economy, the Report refers (para. 60) to a broad spectrum of subjects where its decisions are capable of making a positive contribution: the level of official foreign currency reserves and encouragement to private firms to build up a liquidity buffer; switching of its borrowing from foreign to domestic currency and from short-term to longer-term instruments; the purchase of options or contingent credit lines allowing borrowing at a predetermined rate of interest in times of crisis; encouraging corporations to shift their financing away from debt towards equity; (for commodity-importing countries) buying forward contracts or call options fixing prices; and (presumably for commodity-exporting countries) issuing bonds whose cost of servicing and repayment is linked to export prices. The Report nonetheless cautions (para. 64) against excessive expectations concerning the advantages of employment by the public sector of complex financial instruments to manage risk caused by such factors as the newness of the markets for these instruments and consequent uncertainties concerning price-setting and liquidity, counterparty credit risk, and the difficulty of designing hedging strategies for risks which are hard to define or to disaggregate into components for which hedging techniques exist.

The focus of this discussion of the role of the public sector might be described as the identification and reduction of general vulnerability to certain risks. Several subjects which one might expect to see included, had the discussion also been more concerned with responding to the threat of imminent or looming financial crises, are not addressed. One, for example, is the need for information on private economic actors’ large positions (a matter already mentioned above). Another is capital controls and other macroeconomic policies which can be useful in handling instability in capital movements and currency markets. As mentioned earlier, the Report goes along with the increasingly conventional wisdom since the Asian crisis that controls on capital inflows can be a useful policy tool. But rather than taking them up under risk monitoring and management by the public sector – which many would regard as a more natural place – the Report relegates their discussion to the end of section III under the separate heading of such controls as prudential measures. This may reflect the still ambivalent attitude in many official circles towards acceptance of capital controls.<sup>7</sup>

It is instructive to contrast this ambivalence with the very different line on the subject in an EEC directive of 1972 (“on regulating international capital flows and neutralizing their

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<sup>7</sup> Such an approach to capital controls would be also be consistent with the objective of giving an imprimatur only to a restricted set of capital controls and to restricted circumstances, now and in future, in which their use is appropriate.

undesirable effects on domestic liquidity”<sup>8</sup>), which can be regarded as expressing at the time the collective view of a major group of industrial countries as to the appropriate way to protect the newly instituted “snake” arrangement of narrow margins among the exchange rates of EEC currencies and, more generally, the exchange rates agreed at the Smithsonian meeting of December 1971 against pressures resulting from large capital flows. Recital 1 of the directive refers to “exceptionally large capital movements” which “have caused serious disturbances in the monetary situation and in economic trends in Member States”, and recital 3 to the need for Member States to “adopt measures immediately in order to have available, should occasion arise, the appropriate instruments for purpose of discouraging exceptionally large capital movements ..., and of neutralizing their effects on the domestic monetary situation”. Article 1 of the directive defines the appropriate instruments as follows:

- (a) For effective regulation of international capital flows:
  - rules governing investment on the money market and payment of interest on deposits by non-residents;
  - regulation of loans and credits which are not related to commercial transactions or to provision of services and are granted by non-residents to residents ...
  
- (b) For the neutralization of those effects produced by international capital flows on domestic liquidity which are considered undesirable:
  - regulation of the net external position of credit institutions;
  - fixing minimum reserve ratios, in particular for the holdings of non-residents.

As one reads or re-reads the text of this directive, one may well ask the question whether the risks to which it was a response have greatly changed in the interim, or whether the different thrust of international policy which emerged subsequently was not more a reflection of intellectual fashion.

## ***B. The banking sector***

In its sectoral recommendations for banking the Report covers not only the internal controls of firms but also supervisory practices. In its prefatory remarks here the Report lays particular emphasis on the examples provided by recent crises of ways in which different financial risks are often closely connected. As the Report puts it (para. 74):

Exposure to credit risk is increasingly driven by movements in market prices, which themselves depend on the liquidity of these markets. Market risk has long been acknowledged to entail two components: general market risk and specific market risk, the latter being very close to credit risk; but it increasingly includes a liquidity dimension as well, especially when tightened liquidity results in abnormal prices. Conversely, liquidity risk is linked to market risk and, in extreme cases, to credit risk alike. As the industry and regulators evaluate a bank’s overall capacity to withstand shocks, each risk should be considered in the context of the bank’s overall portfolio, no longer in isolation.

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<sup>8</sup> Council directive of 21 March 1972 (72/156/EEC) reprinted in the Official Journal No. L91/13 of 18 April 1972. The directive was subsequently repealed in 1988.

Presumably in view of the unmanageably large range of subjects for banks' own risk management which such remarks potentially open up, the Report limits itself to those of liquidity and foreign exchange risk and to the credit risk arising from capital flows.

Recent financial crises are replete with instances when shortages of liquidity led to outsize movements in the prices of financial instruments or even difficulties in pricing at all such instruments (and thus also valuing the trading books of traders and firms), conditions which are potential triggers for financial panic. Shortages of liquidity can also lead to roll-over risk for economic agents' short-term financing and to re-evaluations of credit risk, both of which are potential sources of cumulative instability owing to links among firms. But the Report does not come up with any novel departures in its recommendations: the setting-out of basic principles for management of liquidity by banks in a recent paper of the Basel Committee on Banking Supervision (BCBS, 2000) is welcomed; further stress-testing is supported to obtain a better idea of the way in which liquidity risk is related to other financial risks; and better disclosure is recommended of banks' liquidity policies and positions in their financial reports together with a requirement for auditors and supervisors to validate the assumptions underlying these policies.

In its remarks on credit risk the Report places special emphasis on the way in which large movements in exchange rates and the prices of financial assets have translated into increased credit risk during recent financial crises in emerging-market economies. The Report does not pretend that there is any silver bullet available to deal with the resulting problems. The management of credit risk ultimately depends on good credit assessment and control by banks and by other investors and lenders, and these in turn can be facilitated by improved disclosure (though it should be recalled that there are limits to what can reasonably be expected on this front, as discussed earlier). Even in industrial countries management by banks of credit risk suffers from many weaknesses. As a senior executive at a large Australian bank with extensive practical experience of different aspects of banks' capital allocation puts it in a new book: "Although this is by far the biggest risk class for most banks, and has been around since the start of banking, techniques and understanding still lag behind the market risk class ... This is despite the fact that history shows that it is bad management of credit risk which is most likely to lead to bank failure" (Matten, 2000: 185). Some of the most important problems to be confronted here involve concentrations of credit risk, which are often determined by correlations among the positions of economic agents and sectors which are hard to identify until they actually manifest themselves – and hence have been dubbed in some cases "latent concentration risk" (Caouette et al., 1998: 91 and 240). Recent financial crises have provided many examples of how the credit risks of economic agents are correlated as a result of factors other than high mutual financial exposures.

The discussion of the credit risk associated with capital flows is one where the focus on borrowers mandated by the Report's terms of reference leads to the absence of a serious, separate treatment of deficiencies in lenders' credit controls (though some of its recommendations apply equally well to lenders). Yet such deficiencies are a major feature of international debt crises. Observers of the crisis of the 1980s remarked on the way in which it was preceded by aggressive selling of loans to developing-country borrowers, often accompanied by wholly inadequate analysis of their capacity to repay.<sup>9</sup> Similar sloppy application of credit analysis and standards

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<sup>9</sup> One correspondent, apparently quoting a Mexican banker, noted that "The banks sent salesmen to Mexico, not analysts. Promotions and bonuses resulted from deals and profits, not from mealymouthed excuses" (Delamaide, 1984: 102).

seems to have accompanied much lending to emerging-market countries in the 1990s, leading to losses for foreign banks during the Asian crisis, for example, of approximately \$20 billion, according to some estimates.<sup>10</sup> The way in which credit guidelines are applied in banks' lending decisions and the balance in these decisions between conservatism and aggressiveness (sometimes called a bank's "credit culture") remains a little researched subject. A more complete treatment of ways to control instability in cross-border lending than that covered by the Report would need to address certain behaviour patterns in banks in countries which are the main sources of international capital flows as well as ways to improve their decision-making regarding credit allocation.

Many of the Report's remarks on banking regulation and supervision consist of endorsement of ongoing international initiatives to improve practices in this area. Particular issues addressed include banks' provisioning practices (where higher general provisions are supported as a way of alleviating cyclical contractions in lending due to declines in borrowers' creditworthiness), on-site supervision (the frequency of which is subject to considerable variation amongst countries but the importance of which is endorsed here<sup>11</sup>), and greater use of macroprudential assessment based to a significant extent on the kind of data in national balance sheets discussed above.

Perhaps the most interesting of the Report's remarks on banking regulation and supervision (para. 97) concern countries where the supervisory regime is not adequate or supervisory resources are scarce. Here the Report draws attention to the possibility of using "a set of more explicit regulations dealing notably with liquidity and foreign exchange exposures". These include the following:

- (i) limits could be placed on open long or short positions in foreign currencies as a percentage of capital;
- (ii) minimum holdings of liquid assets, meeting a well-defined criterion, could be required in order to provide sufficiently for liquidity risk arising from foreign currency liabilities;
- (iii) requirements could be tiered so that lower reserve/liquidity ratios apply to long-term foreign currency borrowings;
- (iv) reserve requirements, with or without remuneration, could be imposed to discourage foreign currency funding;
- (v) regulations could require banks to match fund maturities of foreign currency assets and liabilities, and more stringent, minimum maturities could be imposed on foreign currency funding;

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<sup>10</sup> See Zonis and Wilkin (2000). (This article, written by two members of the Chicago-based political-risk consulting firm, Marvin Zonis and Associates, contains a useful, if brief, account of institutional deficiencies in banks' assessment of country risk.)

<sup>11</sup> Concerning the frequency of on-site supervision in the early 1990s in a sample of 23 (principally industrial countries) see Cornford (1999, sect. III. B).

- (vi) regulations could require banks to hedge their foreign currency risk exposure in transactions and to ensure that their borrowers hedge their exposure as a condition for obtaining loans from banks; and
- (vii) to lower credit risk, foreign currency loans could be restricted to a fixed percentage of capital, or banks could be required to hold more capital and/or loan-loss reserves against these loans.

What is particularly striking about these recommendations is that they might be classified as capital controls. Like those on capital controls as prudential measures discussed below, these recommendations are an indication of the increasing back-door acceptability of such controls, but also seem to reflect a certain continuing reluctance to classify them as part of the panoply of appropriate instruments of macroeconomic policy.

### ***C. The non-bank financial and corporate sectors***

Under this heading the Report includes financial institutions not classified as banks (such as finance companies in Thailand or merchant banks in the Republic of Korea) as well as non-financial firms. With regard to the former the Report largely limits itself to endorsement of international initiatives already under way. With regard to the latter its recommendations include appropriate levels of leverage, better corporate governance and disclosure, and the avoidance of incentives to short-term borrowing in the government's regime for capital transactions. The Report notes the desirability of information on non-financial corporations' exposure to financial risks as part of the national balance-sheet data at the core of the Report's approach to the monitoring and managing of such risks. But it acknowledges that in many countries this would require radical changes in the regimes of financial reporting for such firms.

### ***D. Capital controls as "a prudential measure"***

Attention was drawn earlier to the way in which discussion of capital controls is relegated in the Report to the heading of prudential measures, rather than being taken up as a major instrument for the management of economy-wide risks by the public sector. Both the classification of certain capital controls as being of a prudential nature and the Report's exclusion of controls on capital outflows from its purview are worthy of further comment.

Deregulation of the banking industry since the 1970s has been associated with the relaxation of official controls over key financial indicators, such as interest rates, and with the decartelization of the markets for various banking services, as a result partly of government policy and partly of competitive pressures driven by technology. The policy response to the increased risks due to deregulation has included strengthening of prudential regulation and supervision, particularly in the form of a better alignment of prices and costs in banking operations with the risks involved, of higher levels of capital to meet unexpected losses, and of improved guidelines for, and supervision of, banks' own internal control of risk. Many of the measures of this prudential regulation are in the form of rules about different components of banks' balance sheets such as requirements for minimum levels of capital or liquidity. Measures of this kind overlap with certain instruments of monetary policy which may involve rules about the minimum levels of liquid assets to be held by banks, or the rates of interest at which the

monetary authority is prepared to engage in repo operations,<sup>12</sup> or other short-term borrowing from and lending to banks and other agents in the financial markets (thus influencing their liquidity).

Such overlapping makes it difficult in many areas to draw a precisely located line between measures of monetary policy, on the one hand, and of prudential regulation of financial firms, on the other (a difficulty which need not be all that surprising since the major objectives of policies under both headings include systemic stability). The EEC directive of 1972 discussed in section III.A above exemplifies this statement, since the instruments of policy recommended therein for “effective regulation of capital flows” and for “neutralization of those effects produced by international capital flows on domestic liquidity which are considered undesirable” are presented as components of macroeconomic policy but evidently would also have prudential implications for banks. Classification of capital controls as prudential measures fits quite naturally into a conceptual framework which acknowledges this overlapping, since it involves the extension of the notion of a prudential measure to the national balance sheet as a whole, and in many cases<sup>13</sup> the controls might anyway consist of rules for the balance sheets of financial firms which could also be classified as “prudential” in the narrower, traditional sense.

The Report justifies the exclusion of controls over capital outflows from its purview on the grounds that these “should be thought of more as an element of crisis management and, as such, are beyond the scope of this paper”. However, the Report does not define what it means by controls on capital outflows. Indeed, some of the controls it endorses (such as some of those recommended for economies with weak regulation and supervision – see section III.B above – or the minimum holding period for direct and portfolio investment from abroad in Chile’s regime for capital transactions) might be classified as controls over outflows. The key to understanding what controls the Report is prepared to endorse in appropriate circumstances may lie in the meaning it intends to give to the term “market-based regulations”. If these are understood to be measures affecting incentives to lend or invest through their impact on the costs or other terms of the contracts in question, then such measures can be considered as being directed at the economic decision leading to capital inflows, and in this sense as controls over them. If this interpretation is correct, then the controls over capital outflows which the Report omits from its discussion are mainly those involving direct restrictions on, or prohibition of, capital transfers from residents to non-residents.

#### **IV. BUILDING INSTITUTIONAL CAPACITY**

Under this heading the Report begins with the markets needed “if market participants are to evaluate and manage risks” (para. 119). Here it singles out the development of domestic bond markets, the importance of well-functioning equity markets, and increased use of derivative instruments provided either by domestic or by international institutions and markets.

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<sup>12</sup> Repo operations refer to short-term borrowing and lending collateralized by securities.

<sup>13</sup> The measures recommended by the Report for countries with weak regulation and supervision, which were discussed in section III.B, provide a number of examples.



The Report's treatment of these issues is summary. The development of domestic bond markets, which is currently being strongly promoted by some international institutions,<sup>14</sup> is to provide an alternative source of financing to domestic bank-lending, especially in times of financial stress.<sup>15</sup> But this raises the question of how far domestically issued bonds could be expected to replace borrowing from banks at such times and thus contribute to preventing crises in the banking sector becoming more generalized financial crises and to facilitating exit from them. Moreover, the Report does not take up the important question of foreign access to domestic bond markets. It might be argued that so long as bonds are denominated in domestic currency, during crises characterized by rises in interest rates foreign investors would be discouraged by the fall in the price of bonds in that currency from liquidating their positions, thus reducing pressures for depreciation. However, actual experience of links between outflows of foreign investment from equity markets (where assets are also denominated in the local currency) and pressures on currencies during crises in emerging-market countries does not offer grounds for much optimism on this score.

Derivative instruments can of course serve important functions for the purpose of risk management. But the Report's blanket endorsement ignores their potential for also being a source of problems for both economic agents and supervisors. It might have been more appropriate if a working group of a body intended to foster financial stability had advocated expanded use of derivatives only subject to a reasonable expectation that economic actors were capable of exercising effective internal control over such instruments as well as to the existence of adequate capacity for supervising their use.

The remainder of the section on building institutional capacity focusses principally on the transparency of the public sector, where its recommendations are closely connected to those on the need for comprehensive national balance-sheet data, including those of the public sector (discussed in section III above), and on the development of capacity in the areas of bank regulation and supervision and of private risk management. Favourable reference is made in the latter context to the joint IMF/World Bank Financial Sector Assessment Programme (FSAP). The FSAP was established as part of the initiatives on standard-setting in the context of international financial reform, and is currently operating on a trial basis in countries which have volunteered to participate. The emphasis of the Report is more on the FSAP's contribution to identifying and

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<sup>14</sup> See, for example, OECD (1999: 61–78), which contains data on the scale of the bond markets of Asian countries in relation their GDP, as well as a discussion of regulatory, tax and institutional features identified as responsible for holding back their development in these and other developing countries.

<sup>15</sup> This point has been made on a number of occasions by Alan Greenspan, Chairman of the Board of Governors of the United States Federal Reserve System. See, for example, Greenspan (2000), where he said: "These recent crises have underscored certain financial structure vulnerabilities that are not readily assuaged in the short run but, nonetheless, will be increasingly important to address in any endeavor to build formidable buffers against financial stress. Among the most important, in my judgment, is the development of alternatives that enable financial systems under stress to maintain an adequate degree of financial intermediation even should their main source of intermediation, whether banks or capital markets, freeze up in a crisis. The existence of multiple avenues of financial intermediation has served the United States well in recent decades, especially during the credit crunch of the late 1980s and more recently when our capital markets froze up in 1998 following the Russian default." The view is expressed in OECD (1999: 71) that "The lack of development of Asia's local debt market exacerbated the crisis, as during the financial crisis, there was an abrupt loss of international market access". However, it is hard to believe that the access of borrowers even to a better developed local bond market could have been largely maintained in the conditions of a currency-cum-banking crisis which drastically restricted access to external financing.

remedying vulnerabilities in the financial sector than on its role in the assessment of compliance with international standards and codes.

## V. DATA ON EXTERNAL FINANCIAL POSITIONS

This section of the Report addresses various shortcomings in statistical reporting systems revealed by recent financial crises and refers to requirements under this heading in creditor as well as debtor countries. Much of the discussion concerns initiatives already under way for improvements in data on external debt, foreign exchange reserves, and the international investment position (IIP, the balance sheet of a country's external financial assets and liabilities), and various suggestions are made as to ways in which these initiatives could be usefully extended. References are made to improving the periodicity of data but on the whole the improvements discussed, while making possible better and more timely analysis of country risk, would still fall short of those required to deal with many of the kinds of financial stress which countries may now experience as a result of the increased integration of financial markets (some instances of which were mentioned above in section II).

A crucial requirement in this context is the monitoring of various assets, liabilities and related items, including the large positions of private economic agents, on a short-term basis. Here the main progress mentioned in the Report concerns the new template for a country's international reserves which has been incorporated in the IMF's Special Data Dissemination Standard (SDDS), and under which subscribers will disseminate data on reserves and related items (including actual and potential short-term obligations) on a monthly basis, with a lag of no more than one month. With respect to private economic agents' large positions, the Report notes (para. 150) that:

With the assistance of the IMF, systems for high frequency monitoring of the external liabilities of domestic financial institutions were established in a small number of countries to expand their capacity to manage crises and to provide early warning of emerging problems. The coverage of the monitoring systems has been limited to interbank transactions of domestic banks (including their offshore branches and subsidiaries) vis-à-vis foreign banks. The monitoring systems typically cover a large proportion of the domestic banking sector and entail the collection of weekly information, with reports on roll-over rates, changes in exposure, changes in average maturity, and changes in spreads.

Such monitoring would appear to represent progress in the direction of a form of reporting which could assist a country's authorities in anticipating and managing periods of financial stress. However, the Report is tantalizingly lacking in detail concerning how these systems of high-frequency monitoring work. Moreover, the monitoring does not seem to include the exposures of non-bank financial firms (a category which would comprise the hedge funds whose activities have been a subject of concern for a number of Asian countries since the region's financial crisis), and falls short of the demands for improved disclosure now being debated in some countries.<sup>16</sup>

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<sup>16</sup> See, for example, the following statement in RBA (1999b): "There is a need for enhanced information ... concerning market concentration. One way of addressing the market concentration issue is to require some form of large position reporting, where large positions are defined in terms of the relevant market. For example, institutions could be required to disclose positions that account for more than some percentage of a market's turnover or outstanding contracts. The benchmark levels for disclosure could be determined by national regulatory agencies, or through international agreement, perhaps through the BIS. At one extreme, institutions might be required to notify the authorities of the specific details of positions that exceeded the relevant benchmark. A less

Initiatives going beyond the high frequency-monitory mentioned above have been under discussion in working groups of the Committee on the Global Financial System. One of these, that on Transparency Regarding Aggregate Positions (the Patat Group), had a mandate to look at what aggregate data on financial markets could be collected to enhance their efficient operation. The second, that on Transparency Regarding Individual Positions (the Fisher Group), is concerned with ways in which large financial institutions, including non-banks, might be encouraged on a voluntary basis to make available to clients and lenders a greater range of information on their risk profiles in the interest of improving systemic stability, removing, for example, threats to liquidity or to institutions' access to financing resulting from inadequate information. The initiative involving the Patat Group appears to have been abandoned because of the finding that "it would not be possible to obtain adequately comprehensive and timely information on a voluntary basis, and legislative solutions were deemed impractical" (White, 2000: 22). Neither of these initiatives is mentioned in the Report. Moreover, the possibility of alternative initiatives on the part of individual countries concerned by their lack of such information is not raised. These might take the form, for example, of the removal in a country's regulations of various legal protections from transactions between its domestic entities and foreign counterparties which refused to provide such information. In this context a point made by a well-known authority on banking issues is worthy of recall: "markets do not create the legal order; the legal order enables the markets ... The felt need of the participants [in the markets] is for 'legal certainty'. A price can be charged for that" (Mayer, 1999: 48).

## VI. CONCLUDING REMARKS

An important departure of this Report is its attempt to confront policy problems connected to the multiplication of fault lines in the global network of financial markets that has resulted from greater integration and the proliferation among financial firms of new techniques for managing cross-border exposures to financial risk. The Report's main weakness is its inadequate treatment of features of the behaviour of international investors and lenders, as opposed to that of borrowers and other recipients of capital flows, as well as of rules in the countries where the former operate. No doubt this can be explained to a significant extent by the mandate of the Financial Stability Forum's Working Group on Capital Flows, which had the effect of diverting its attention from global macroeconomic factors driving capital flows. But this weakness may also reflect a widespread assumption in lending and investing countries that the main flaws of the otherwise largely beneficial system of international capital movements which has come into existence since the 1960s are to be found in weaknesses in recipient countries, which should therefore be responsible for the lion's share of the adjustments needed to reduce the likelihood of financial crises. Thus, a major aim of this commentary has been to indicate ways in which the Report's set of recommendations are connected to a perception of problems inherent in the existing regime for capital flows that is, in significant respects, partial and one-sided.

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intrusive approach would be to require some form of public reporting in which institutions periodically disclose whether they had 'large' positions in certain markets, but were not required to disclose specific details of those positions."

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