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Standards for Crisis Prevention

Once upon a time, long, long ago in a place far, far away, crisis prevention and crisis management were so straightforward that they could be delegated to macroeconomists. Currency crises were caused by recklessly expansionary monetary and fiscal policies that resulted in excess demand, overvalued exchange rates, and unsustainable current-account deficits. Preventing them meant restoring monetary and fiscal balance before these excesses got out of hand. For the IMF, crisis management meant providing temporary financial assistance so that macroeconomic retrenchment did not produce or aggravate recessions. It meant conditioning that assistance on the restoration of monetary and fiscal discipline. It was not necessary for those whose objectives were the maintenance of exchange rate and macroeconomic stability to concern themselves with a country's financial nuts and bolts—that is, with bank supervision and regulation, auditing and accounting, bankruptcy procedures, and corporate governance. One can question whether things were ever so simple, but there is some truth to the view that for its first half century the IMF rightly focused on countries' monetary and fiscal policies and was only tangentially concerned with their internal institutional arrangements.

In Asia (and, for that matter, in its other recent programs), the IMF has become more deeply entangled in countries' internal affairs. It has sought to encourage the authorities to improve prudential supervision, root out corruption, eliminate subsidies, break up monopolies, and strengthen competition policy. In virtually every program country, this has incited a backlash against the Fund, which is resented for its intrusiveness. Martin Feldstein (1998a) and others have questioned whether such intimate involvement in the internal affairs of sovereign states is really necessary for the restoration of currency stability. What business is it of the Fund, Feldstein asks, to demand that Indonesia scale back its national car program or break up its clove monopoly? The IMF, in this view, should focus on the monetary and fiscal imbalances that are at the root of balance of payments problems. Not only does the Fund lack a secret formula for how every country should organize its internal affairs, but its advice is more likely to receive domestic backing and to be sustainable politically if it avoids infringing unnecessarily on the sovereignty of its members.

This view sits uneasily with the fact, widely acknowledged, not least by Feldstein himself, that monetary and fiscal profligacy was not endemic in Asia in the period leading up to its crisis. Since monetary and fiscal excesses were not at the root of the crisis, how then can it make sense to recommend focusing on monetary and fiscal variables when devising a response? The problem and the solution must lie elsewhere.

A hint to its location follows from the observation that high international capital mobility has all but erased the line between the domestic and international financial systems. This makes it impossible to ''fix'' the *international* balance of payments without also ''fixing'' the *domestic* financial system. So long as the domestic and international financial systems were strongly segmented by capital controls, balance of payments deficits arose out of current-account deficits that were financed with international reserves. Restoring balance of payments equilibrium meant restoring balance to the current account, which implied the need to restrict monetary and fiscal policies. But now that capital is so mobile internationally, stabilizing the balance of payments means stabilizing the capital account, which requires restoring investor confidence. And restoring investor confidence means restoring confidence in the stability of the domestic financial system.[1]

Inevitably, this draws those seeking to prevent and limit the severity of crises into involvement in the supervision and regulation of banks and corporations issuing publicly traded securities. It directs attention to auditing and accounting, the disclosure of financial information, and corporate governance. Recent models point to banking system weaknesses, the opacity of balance sheets, and moral hazard from government guarantees as the causes of currency and financial crises (e.g., Dooley 1997; Krugman 1998a).[2] Guarantees encourage excessive foreign short-

1. In the language of appendices B and C, the balance of payments disequilibrium does not reflect a flow problem (that the flow of government expenditures and the flow supply of new domestic credit emissions exceed the current period's additions to demand), as in first-generation crisis models. Rather, it is a stock problem, in which investors skeptical of the liquidity or solvency of the banking system have to be induced to hold the outstanding stock of bank liabilities rather than shift into foreign exchange.

2. The point applies not just to the Asian crisis. Thus, postmortems on the 1992 European and 1995 Mexican crises, while focusing on other factors as the proximate source of financial

term funding of the banking system, while directed lending leads banks to invest in low-return projects that ultimately damage their balance sheets. The fragility of the financial system then prevents the authorities from mounting a concerted defense of the currency. Inadequate auditing and accounting prevent investors from distinguishing good banks from bad and set the stage for economywide banking crises, while poorly designed or enforced insolvency procedures precipitate creditor grab races and cascading debt defaults. The undeniable implication is that far-reaching institutional reforms are needed to root out the causes of financial crises.

The problem is that neither the IMF nor other international financial institutions have sufficient staff and expertise to proffer advice in all these areas. The Fund cannot realistically master the regulatory particulars of banking systems in all 182 member countries. Hiring or borrowing bank supervisors from its members would simply remove them from where they are needed most urgently. The problem grows more severe when one turns from bank regulation to auditing and accounting, insolvency codes, and corporate governance—issues in which macroeconomists have little formal training or experience.

At the same time, problems in these areas are too pressing to do nothing about. The response to those who say that financial supervision, auditing and accounting, insolvency and reorganization procedures, and corporate governance are mere window dressing is that institutional arrangements in these areas are key to financial stability in our modern world. If the Asian crisis has taught us one thing, it is that countries cannot restore exchange rate and balance of payments stability without rectifying deficiencies in their domestic financial systems.

The Standard Solution

The only feasible approach to this problem is for national governments and international financial institutions to encourage the public and private sectors to identify and adopt international standards for minimally acceptable practice. National practices may differ, but all national arrangements must meet minimal standards if greater financial stability is to be achieved. All countries must have adequate bank supervision and regulation. All must require financial-market participants to use adequate accounting and auditing practices. All must have transparent and efficient insolvency codes. The particulars of these arrangements can differ—countries can reach these goals by different routes—but any country active on international financial markets must meet internationally accepted standards.

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difficulties, point to the weakness of banking systems as one important reason why governments were unable or unwilling to defend their currencies when these came under attack (see, inter alia, Eichengreen and Wyplosz 1993).

An advantage of this approach, along with its ability to accommodate variations in national traditions and economic cultures, is that the burden of setting these standards need not fall primarily on the IMF, multilateral institutions in general, or even national governments. In most cases, the relevant standards can be identified or defined by private-sector bodies. Although those entities can be aided in their work by officials, the role for international institutions should be limited mainly to recognizing those standards, urging adoption by their members, monitoring compliance, and—in the case of the IMF—conditioning its assistance on a country's commitment to meeting them.

This approach is very different from that of the G-7, the G-22, and the IMF, which emphasize the role of official bodies in the process of standard setting and enforcement. It is different from that of commentators such as Richard Dale (1998), who suggests that responsibility for standard setting and enforcement should be lodged in a single international agency. It differs from Henry Kaufman's proposal to create a new international institution to establish uniform capital standards and trading, reporting, and disclosure standards and to monitor the performance of financial institutions and markets (Kaufman 1998a, b).[3] It will be obvious that the problem is not just one of limited expertise. In addition, there would be strong resistance, and not only in the United States, to the idea of vesting such formidable powers in the hands of an international institution.

Fortunately, the relevant private-sector bodies already exist. In accounting there is the International Accounting Standards Committee (IASC), consisting of representatives of the accounting profession from 103 countries at last count, which promulgates international accounting standards.[4] There is the International Federation of Accountants, with parallel membership, which has gone some way toward formulating international auditing standards.[5] The International Organization of Supreme Audit Institutions (INTOSAI) similarly issues auditing guidelines and standards. Committee J of the International Bar Association is developing a model insolvency code to guide countries seeking to reform and update their bankruptcy laws. For corporate governance there is the International Corporate Governance Network (ICGN), which seeks to improve standards of business management and accountability worldwide.

3. I return to these ideas in chapter 6.

4. The objectives of the IASC as stated in the committee's constitution (see http://www.iasc.org.uk) include formulating and publishing "accounting *standards* to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance . . ." (emphasis added). Thirty-eight standards have been issued at the time of writing.

5. In addition, the federation, in its discussions, has paid special attention to the role that sound accounting practices can play in the development of capital markets in emerging economies.

In other areas, responsibility for setting standards has been taken on by international committees of regulators. In securities-market regulation there is the International Organization of Securities Commissions (IOSCO), which serves as a forum for securities regulators and has established working groups to set standards and coordinate regulatory initiatives. For bank regulation there is the Basle Committee on Banking Supervision, made up of supervisors from the leading industrial countries, whose Core Principles for Effective Banking Supervision codify Morris Goldstein's 1997 seminal argument for an international banking standard.[6] But even in these areas where regulators have taken the lead, there is a role for the private sector—for example, the world's largest financial institutions would develop standards for monitoring and managing financial risks, and the Basle Committee would utilize these when setting international standards for risk-management practices (G-30 1997).

Multilaterals are already active in a number of these areas, helping to identify standards or coordinating the process through which others agree to them. Thus, the Organization for Economic Cooperation and Development (OECD) issued a report in 1998 on global principles of corporate governance, focusing on the accountability of management, disclosure and transparency, and communication with shareholders (OECD 1998). The United Nations Commission on International Trade Law (UNCITRAL) has adopted a model law on the treatment of cross-border insolvencies. The IMF has established a Special Data Dissemination Standard for the provision of economic and financial information by countries seeking to access international capital markets. It has promulgated a code of fiscal transparency to be adopted as a standard of good fiscal practice by its member countries and anticipates developing an accompanying code for monetary and financial practices. In all these cases the multilaterals have solicited guidance and advice from national officials and private-sector experts.

The role of the IMF and other multilaterals would be more than simply to encourage the activities of these self-organizing groups. Rather, they should actively consult with these groups (as the Fund already does with IOSCO and the Basle Committee), seek status as ex officio members, and certify the standards that they identify as measures of best practice. Active involvement in the standard-setting process, by the IMF in particular, is necessary if the Fund is to assume "ownership" of the standards it helps to set. To give teeth to its advice, the Fund should condition the disbursal of assistance on program countries meeting those standards. It will need to encourage countries to apprise the markets of their compliance, which

6. There is a sense, then, in which the proposals of this chapter are essentially a generalization of Goldstein's approach to the bank instability problem.

it would monitor in conjunction with its Article IV surveillance. Finally, the Fund should make public its assessment of compliance as a way of strengthening market discipline.

A more active role for the IMF and the other international financial institutions in the promulgation of standards would be a departure from past practice. But there is no alternative once one acknowledges that the Bretton Woods institutions do not possess the resources to develop standards in all these areas themselves. The process will be complicated, but the alternative—inaction—is no longer viable. There is no alternative to proceeding by way of collaboration between the public and private sectors.

Some Examples

Examples of this process include existing standards for bank supervision, securities-market regulation, data dissemination, and corporate bankruptcy reform.

Bank Regulation

The BIS already provides a venue for national bank supervisors and regulators to pool their expertise and develop international standards for bank regulation. Since 1975, prompted by the failure of the Herstatt Bank, the Basle Committee (consisting of representatives from the bank supervisory authorities of the major industrial countries) has met three or four times a year and convened a number of technical subgroups. The Basle Committee periodically consults with and attempts to gain the support of other supervisory groups such as IOSCO.

The high-water mark in the Basle process remains the 1988 Basle Capital Accord. Signatories agree to hold their banks to minimal capital requirements of 8 percent of risk-weighted assets.[7] The 1995 Market Risk Amendment permits banks to use their proprietary models to calculate correlations among and within broad risk categories (such as interest rate risk, exchange rate risk, and equity price risk) in order to come up with more economically sophisticated risk weights, and the 1997 Core Principles for surveillance of banking and financial systems identifies five categories of standards for sound supervision and regulation.[8] The Core Principles

7. Assets are divided into four or more risk categories (e.g., commercial loans, mortgage loan, interbank debt, and government debt), and a risk weighting is established for each.

8. Significantly, the Core Principles were negotiated by the Basle Committee in cooperation with representatives from emerging-market countries. They were endorsed by G-10 central bank governors in April 1997 and by G-7 finance ministers in June. The 25 basic principles fall under five headings: preconditions for effective banking supervision (such as granting supervisors political independence and legal protection), licensing and structure (giving supervisors the authority to see that applicants for bank licenses have a proper operating

have been embraced by the IMF, which is helping to disseminate them to its members (see Folkerts-Landau and Lindgren 1998).

The Basle Capital Accord and the Core Principles demonstrate the feasibility of standard setting in the financial realm. At the same time, this case is revealing of the difficulty of the approach. The Committee on Banking Supervision has no enforcement power.[9] Most of its recommendations are undemanding minima; countries attaching a higher value to domestic financial stability have seen fit to opt for significantly more demanding standards.[10]

Notwithstanding the limited scope of these standards, agreement has been difficult to reach. The committee makes decisions by consensus, which allows dissidents to hold up progress. Representation on the Basle Committee is limited to high-income, financially developed economies. The Basle Capital Standards are designed to apply only to international banks. These limitations are all indicative of the difficulty of negotiating standards in all the relevant areas.

Securities-Market Regulation

A second example of standards-related work already under way is in the area of securities-market regulation. The most important organization in this area is the International Organization of Securities Commissions, a forum for cooperation among national securities regulators headquartered in Montreal. Its regular membership consists of government regulators of securities and futures markets such as the US Securities and Exchange Commission (those of nearly 150 member agencies from 94 countries at

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plan, internal controls, and capital base), methods of ongoing bank supervision (including on-site and off-site inspections), information requirements (giving supervisors responsibility for seeing that each bank maintains adequate records and uses consistent accounting policies), and cross-border banking (that supervisors practice global consolidated supervision of home-country institutions and exchange information with other national supervisory authorities) (see BIS 1997). I return to these points in chapter 4.

9. The Basle Capital Standards are merely recommendations; nothing requires countries to accept them.

10. In addition, the Basle Standards as currently constituted say nothing about minimum capital requirements for nonbank financial institutions, notably hedge funds. And given the footloose nature of these funds (that is, their option of legally domiciling themselves in offshore tax havens), the Basle approach could not be used to address their behavior short of expanding the BIS to the point where country membership was universal and compliance with its standards was obligatory, neither of which is realistic. The only effective way of dealing with the hedge fund problem is, on the creditor-country side, to strengthen regulation of the commercial banks providing them credit and, on the debtor-country side, to use Chilean-style capital-inflow taxes to make it more difficult for hedge funds to get in and out of emerging markets (see chapter 4).

last count).[11] Essentially all countries with stock exchanges are represented, giving IOSCO a more broadly based membership than the Basle Committee. IOSCO consults extensively with international organizations, including the IMF.

IOSCO initially concentrated on coordinating efforts to curb and punish securities fraud, encouraging its member commissions to adopt bilateral and multilateral agreements to initiate proceedings against those suspected of committing such fraud in jurisdictions other than their own. Following the failure of Barings PLC, it turned its attention to a wider range of regulatory issues with implications for systemic risk.[12] Its Technical Committee has made recommendations regarding trigger levels for identifying large exposures on futures exchanges, for developing information-sharing agreements among regulators, for developing standards for transparency in the case of default procedures, for the disclosure of customer positions, and for best practice in the treatment of positions, funds, and assets in the event of default. Its working group on multinational disclosure and accounting has identified accounting issues that should be included in a core international accounting standard to be recognized by members. In 1995 it reached an agreement with the IASC on a schedule for establishing an international accounting standard to be used for quotations on all stock exchanges. In 1997 it circulated for consultation a draft setting out core principles for securities regulation. In 1998 it issued for public comment a set of international disclosure standards for cross-border offerings and initial listings by foreign issuers. It is working with the Basle Committee and the IASC to develop standards for the consolidated supervision of industrial groups and conglomerates.

IOSCO's broad membership, encompassing emerging as well as advanced industrial countries, positions it to address issues relevant to emerging markets. It operates an Emerging Markets Committee that "endeavours to promote the development and improvement of emerging securities markets by establishing principles and minimum *standards* . . ." (see http://www.iosco.org, emphasis added). Much of the discussion at its annual meetings is concerned with issues related to securities regulation in emerging markets. Thus, IOSCO illustrates the feasibility of extending standards-related work to financial issues relevant to emerging economies.

That said, international agreement has been elusive. Agreeing on accounting standards for research and development, discontinued busi-

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11. It does not include self-regulating organizations like the Board of the New York Stock Exchange or the National Association of Securities Dealers. The self-regulating organizations are, however, represented on a consultative committee.

12. Its work program is expressly designed "to develop high-quality *standards* and promote market integrity through a process of member consensus and cooperation" (Folkerts-Landau and Lindgren 1998, 72, emphasis added).

ness, lease contracts, and retirement provisions has been especially problematic. IOSCO recommendations are advisory and nonbinding on members. The organization has no enforcement powers.

Data Dissemination

Another precedent is the IMF's initiatives on the data dissemination front. Its General Data Dissemination System (GDDS) and the Special Data Dissemination Standard are clear international standards (a fact evident in the latter's name). The SDDS, targeted at countries possessing or seeking access to international capital markets, is intended to provide them a standard for the provision of economic and financial data to the public.[13] Countries subscribe voluntarily, but in doing so they commit to providing information to the IMF about their practices in disseminating and publishing 17 categories of economic and financial data.[14] They agree to take specific steps to improve data integrity, data quality, and access to data and to emphasize transparency in the compilation and dissemination of statistics. They are encouraged to announce publication calendars in advance, to make data available simultaneously to all interested parties, and to describe the terms and conditions under which official statistics are produced. They are urged to document their statistical methodology and frameworks to assist users in assessing data quality. The IMF operates an electronic bulletin board where information on countries' subscription status can be found, with electronic hyperlinks to national sources of the data.[15]

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13. Whereas the SDDS focuses on data dissemination by countries that generally already meet high-quality data standards, the GDDS concentrates on improvement in data quality generally, including in those countries that have not secured access to international capital markets.

14. Subscription was opened in April 1996 by a letter from the IMF's managing director to all IMF members and governors. As of September 1998, 46 members subscribed to the SDDS. There is a transitional period through the end of 1998, after which subscribers have committed to be in full observance of the standard. Information about the SDDS bulletin board is available at http://dsbb.imf.org.

15. One can distinguish several rationales for this initiative. First, better information strengthens the ability of regulators and other national officials to recognize problems in their banking and financial systems, enabling them to take prompt corrective action. In the same way, countries' compliance with these provisions can aid the IMF's surveillance activities. Second, subscription status provides an objective indicator of countries' creditworthiness, providing an alternative to the judgments of commercial credit agencies. Investors might become reluctant to lend to countries that fail to subscribe to the standard or might use interest rate spreads to ration credit to them. The hope is that better information will enable capital markets to draw back more smoothly, curtailing their lending more gradually in advance of the buildup of unsustainable pressures. Third, to the extent that bank runs, financial panics, and international contagion are driven by the inability of market participants to distinguish between good and bad credit risks, better information provision by governments and other financial-market participants may help to moderate herd behavior and

The SDDS as currently constituted is far from a complete solution to data-related problems, however. The IMF bulletin board provides only ''metadata''—that is, descriptions of how various statistics are compiled and a road map of where they are found. It does not vouch for or assess the accuracy of countries' economic and financial statistics or even of the metadata, much less analyze the implications of data quality for country risk.

Corporate Bankruptcy Reform

Many emerging markets lack adequate bankruptcy procedures. Where the bankruptcy code is opaque or enforcement is arbitrary, creditors may be reluctant to lend for fear of being unable to collect in adverse states of the world. Moreover, the lack of an efficient bankruptcy procedure can compound the effects of other problems. When business conditions deteriorate, creditors anticipating that the firms to which they have lent will experience financial distress, and lacking confidence that they will be treated fairly, will scramble to liquidate their claims. Thus, the effects of the initial shock can be aggravated by the desire of investors to scramble for the exits. And if borrowers default, the inability of lenders to repossess collateral may produce a cascade effect where the debtor's nonperformance forces its creditors into default. When the creditors include banks, the worst-case scenario is a financial panic.

Many Asian countries entered their crises with archaic bankruptcy codes. Some of these made provision for the liquidation of insolvent enterprises, for example, but not for their reorganization and continued operation. Some made no provision for debtor-in-possession financing—that is, for giving seniority to creditors injecting new money. Their judiciaries lacked the independence and ability to move quickly, frustrating creditors' attempts to take effective legal recourse. This uncertainty about how the legal process would play itself out removed the incentive for the parties to negotiate voluntary workouts in the shadow of the court.[16]

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violent market reactions. Chapter 6 critiques these justifications, emphasizing their limitations.

16. Thailand in 1997 is illustrative. When the crisis erupted, it had an archaic bankruptcy law whose sole purpose was to provide an orderly way of winding down the affairs of insolvent companies; it made no provision for corporate restructurings. It relied on the appointment of a receiver whose powers were limited to preparing a schedule of how the proceeds from liquidation would be distributed among the creditors. It barred creditors who advanced funds with knowledge of the debtor's insolvency from filing claims in bankruptcy proceedings, effectively precluding the provision of debtor-in-possession financing. Information provided to auditors and creditors was incomplete. The courts were lenient in granting adjournments and postponements; most liquidation proceedings took years. Where debt adjustments and restructurings did take place, they proceeded as out-of-court workouts negotiated by the company and its creditors, typically Thai and international commercial banks. Workouts became more difficult when there were numerous bondholders

Repairing this situation is conceptually straightforward. Archaic bankruptcy procedures should be updated. The development of a model bankruptcy code by the International Bar Association and international standards for insolvency and reorganization procedures can give governments the guidance they require. The key steps are strengthening the independence, integrity, and capacity of the judiciary, giving it the power to impose its decisions, and specifying firm deadlines for rendering judgments. While this is easier said than done, Thailand and Indonesia have made progress in the requisite direction even under duress.

For countries experiencing a full-blown economic and financial crisis, bankruptcy reform will have to extend beyond this. Collapse of the exchange rate can complicate restructurings by creating uncertainty about the future price of foreign exchange and hence about the fundamental value of firms. A temporarily weak exchange rate may leave creditors reluctant to settle because they continue to hope that the exchange rate will recover subsequently, enhancing the value of their claims. But the exchange rate is unlikely to recover so long as creditors hesitate to settle and the country's international financial relations are not normalized. To help debtors and creditors break out of this trap, governments have assumed the exchange risk. The Mexican FICORCA and Indonesian INDRA programs provide companies restructuring their debts a limited exchange rate guarantee, with the goal of eliminating some of the risks and costs that would otherwise stand in the way of the successful conclusion of negotiations. Unfortunately, such programs are not always effective, owing to design flaws. The design of such arrangements has not been addressed by the International Bar Association. The international policy community needs to press it or, more likely, another standards-related body to take on this task.[17]

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involved and when bank workout groups were overstretched, as in 1997. By the end of the year, ''loan workouts in Thailand [had become] . . . characterized by a highly disorderly process . . .'' in the words of one set of experts (Darrow, Chandler, and Campbell 1997, 9). One could tell similar tales about other countries.

17. In addition, when many private borrowers find themselves simultaneously unable to service their debts because of the collapse of the exchange rate, it may be necessary to appoint an ombudsman or ''workout czar'' to coordinate their interlocking negotiations. This individual—supported by a small cadre of accountants, lawyers, and economists—would organize meetings of borrowers and lenders, encourage the provision of accurate information on the debtor's financial condition, and act as an honest broker. This approach was tried with some success by the Mexican government following the Tequila crisis when it established a Restructuring Commission (UCABE) to consult behind the scenes with key constituencies and coordinate negotiations. The Thai variant has been for the government to issue a nonbinding 19-point plan to be used as the framework for all corporate workouts involving multiple creditors, backed up by the threat that the government would step in and enforce its timetable for implementing those guidelines if creditors and debtors made insufficient progress. The 19-point plan specified that debt restructuring should involve corporate reorganization as well as new repayment terms, agreement by creditors to a debt

Finally, there is the need to harmonize bankruptcy procedures across countries. Even the most basic feature of a national bankruptcy procedure, the stay on payments, can be vitiated if the debtor has assets in more than one country and if the conditions under which a stay can be imposed differ across them. Not much progress has been made in the last three decades despite a series of international conferences and draft conventions. But as the integration of capital markets proceeds, it becomes more urgent for policymakers to redouble their efforts on this front.

Problems

In several important areas, no consensus exists on what an international standard should entail. Insolvency procedures, for example, differ across OECD countries in the rights they assign creditors and the powers they allot the courts. Even within the European Union, a relatively homogeneous group of nations, efforts to harmonize insolvency laws have come to naught.[18] The debate in the Congress on reform of the US bankruptcy code is indicative that there is not even agreement on these issues within individual countries.

Nor are disagreements limited to economists; they infect other disciplines, notably the law. Corporate governance, to take an obvious example, entails questions of contract enforcement, shareholders' rights, private property rights, and mechanisms for the fair resolution of conflicts among stakeholders, all of which raise sticky legal issues. Little agreement exists on internationally accepted standards for these areas because countries have very different legal traditions and systems. It is optimistic to think that the elements of all of these traditions can be brought under a single international standard.[19]

These are difficult problems. But given that countries coming from all these different traditions will be increasingly active participants on international capital markets, there is no alternative to attempting to define international standards that are general enough to accommodate their different legal traditions but at the same time rigorous enough to

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standstill, and a pledge by creditors to provide timely and accurate financial information (see Bardacke 1998).

18. After many years of preparatory negotiations, a limited convention on insolvency procedures, concerned mainly with establishing common rules of law to adjudicate difficult creditor relationships, was issued in 1995; but it has not been ratified, owing mainly to opposition by the United Kingdom (see Fletcher 1997 for background).

19. Indeed, the efforts of the International Corporate Governance Network to agree on a statement of global corporate governance principles at its third plenary meeting in 1998 revealed deep disagreements among delegates over even the most basic questions (see Taylor 1998).

provide the effective corporate governance and market discipline required for efficient market outcomes.

Enforcement

In some cases, the threat to financial stability arises not from the letter of the law but from how the law is (or is not) enforced. The problem with Indonesia's bankruptcy law, with Indonesia's and South Korea's regulations on connected lending, and with Malaysia's and Indonesia's accounting standards was not so much that they were poorly designed (although this can be argued in some cases) as that they were badly or arbitrarily enforced. Failure to implement or enforce laws can occur for a number of reasons: conflicts of interest, political pressures, corruption, limited administrative capacity, and the absence of an independent judiciary.[20] However much national governments and the international community strive to bring domestic laws into conformance with international standards, their efforts will be of little consequence if enforcement is not fair and vigorous.

The controversy over Indonesian bankruptcy reform is illustrative. Indonesia amended its bankruptcy law at the end of August 1998 to impose a deadline of 30 days for court decisions, set up a new commercial court with specially trained judges, and introduced a 270-day suspension of payments as an alternative to liquidation. It introduced independent receivers for liquidation and administrators for the 270-day stay as alternatives to the state receivership agency. However, there remains a shortage of trained accountants and lawyers, weakening the operation of the receivership and administration system. This has allowed debtors to use the 270-day stay as an opportunity to strip assets and transfer them to the distressed subsidiaries' parent companies. In addition, the courts remain unpredictable. The first case filed under the new law was dismissed on technical grounds (namely that a similar case was already pending against an affiliate). By the end of November, only five cases had been evaluated by the commercial court (of 17 filed under the provisions of the new law), and three of those, including a case against Pacific International Finance, owned by associates of former president of Indonesia Suharto, had been rejected on technical grounds.

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20. The problem of limited administrative capacity is illustrated by South Korean bankruptcy procedures, while that of lack of judicial independence is evident in the case of their Indonesian counterparts. In South Korea, the Seoul district court had only four bankruptcy judges at the beginning of 1998 to handle cases numbering in the hundreds. In Indonesia, "People wish to avoid courts because they are considered expensive, notoriously unpredictable and unreliable. In addition there is a pervasive culture of corruption at all levels. High-profile persons are perceived as exempt from the process. The government may also step in at any point to rearrange the process to suit what it considers its interest" (Gamble 1998, 3).

Enforcement has also been a sticking point in international efforts to strengthen bank supervision and regulation, the area where international standards are most advanced. The Basle Committee's early efforts to strengthen the supervision and regulation of cross-border banking (starting with the Basle Concordat in 1975) focused on the letter of the law. More recently, the IMF, building on the Basle Core Principles, has emphasized the need to establish a legal and political setting in which the relevant regulations will be enforced (see Folkerts-Landau and Lindgren 1998, chapter 7). It has stressed the need to vest responsibility for the function in an independent agency, to ensure that the supervisory authority receives adequate operating income from a source other than the regular budget, and to appoint the head of the supervisory authority to a fixed term in office so that he is protected from the threat of termination. It has recommended that supervisory authorities not be held personally liable for damages caused by any actions legitimately performed in the course of their duties and that they be required to publish periodic reports so that the basis for decisions can be assessed and conflicts of interest can be ferreted out. It has taken steps, in other words, to establish international standards not just for what kinds of bank regulations should be adopted but also for what kind of institutional arrangements should be put in place to ensure that they are enforced.

Thus, the fact that the enforcement of statutes is problematic only reinforces the argument for standards in whose context those enforcement problems can be addressed.

The Role of the International Financial Institutions

While some would say that these are matters best left to the private sector, there are compelling arguments for the multilaterals to be involved. Actively contributing to the process on behalf of their members would put the international financial institutions in a stronger position to insist on compliance by those members. And since the IMF will need to use those standards in its surveillance activities, it will have proprietary information about suitable designs and an interest in seeing that they are appropriately tailored for this use. For all these reasons, it is important for the Fund to take "ownership" of these standards (to apply to it the same terminology it is fond of applying to its members), and this will require it to be actively involved in the standard-setting and dissemination process.

There is no question that the IMF should condition its assistance on implementation of the resulting standards. Countries that borrow from the Fund and whose national practices are judged deficient should be required to take specific steps to bring domestic arrangements into line with international standards as a condition for the disbursal of funds. The

IMF already conditions its assistance, where appropriate, on governments agreeing to close problem banks; from there it is a small step to ask them to reform the ways in which they supervise and regulate the banking system. Similarly, the Fund has already made agreement to reform national bankruptcy procedures a precondition for the disbursal of funds to Indonesia and South Korea; there is no reason that such reforms should be asked only of program countries. To be sure, more work in this area will stretch the expertise and resources of IMF staff to their limit; but the advantage of relying on private-sector bodies to identify standards is precisely that the those standards provide a manual or guidebook of measures to which policymakers and Fund staff can refer.

Finally, the IMF should inform the markets of its members' compliance. The Fund already publishes such information in areas where its Articles of Agreement give it a mandate. Thus, it reports annually on whether each member complies with Article VIII of the IMF Articles of Agreement requiring it to make its currency convertible for purposes of current account transactions. It publishes a table of ''bullet points'' indicating the presence or absence of various categories of exchange and capital controls in its *Annual Report on Exchange Controls and Exchange Restrictions.* In theory, there is no reason why it could not do the same for the IASC's 38 accounting standards, IOSCO's 10 principles for use by securities and futures regulatory authorities, and the International Bar Association's guidelines for a model bankruptcy law. It could issue an annual report that rated countries' compliance in each of these areas.[21]

In some cases this exercise would be straightforward; in auditing, for example, the question could boil down to whether banks and companies were required to hire reputable international accounting firms to examine their books.[22] In other areas, evaluating compliance will unavoidably require a considerable element of judgment, exposing the Fund to complaints of political bias. The difficulty is heightened by the fact that the Fund possesses no explicit mandate for work in this area. And it may find it hard to blow the whistle on countries that fail to comply for fear of compounding their financial difficulties.

These are arguments for relying on the relevant self-organizing private-sector body to carry out the compliance exercise itself wherever possible.

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21. The G-22 and G-7 have suggested something along these lines—an IMF ''Transparency Report''—albeit without providing specifics. The way this exercise is described suggests a relatively limited assessment of transparency. Rather than an annual report akin to *Exchange Controls and Exchange Restrictions* or the European Bank of Reconstruction and Development *Transition Report*, the G-22's and G-7's language suggests a qualitative report on each country in conjunction with its Article IV consultations, limited primarily to fiscal transparency, monetary transparency, and the like.

22. Although the criticism that the World Bank and others have levied on the big five accounting firms raises questions about whether this would be a desirable way to go.

Each committee should be encouraged to establish an electronic bulletin board where such information could be centralized. Hyperlinks could be provided to the Fund's own electronic bulletin board, as they already are for financial-market data. Where the self-organizing committee is composed of national regulators, the rating function could be privatized; it could be spun off to commercial auditing and accounting firms or commercial concerns such as Fitch-IBCA with expertise in the relevant areas.[23] Their assessments might well be subject to the same kind of criticism presently levied at commercial credit-rating agencies, namely, that changes in their evaluations tended to lag changes in actual market conditions. If private-sector assessments are deficient, then the Fund itself should take on responsibility for compliance evaluation. The best way of doing so would be by publishing an annual report, in which it rated each of its member's compliance in each of the relevant subareas.

Incentives for Compliance

One can all too readily imagine an outcome in which countries agree to adhere to an international standard but where actual practice is another matter. What then would be the incentives to comply?

For program countries the answer is clear: the IMF should condition the disbursal of funds on countries taking steps to comply.[24] For the others, having the Fund release its assessment of countries' compliance will encourage the operation of market discipline. But only a subset of IMF member countries is under a program at any point in time, and one can imagine backsliding after a country exits from its program. Market discipline, for its part, is notoriously erratic, as recent events have underscored. There is an argument, consequently, for regulators to reinforce these other mechanisms. Most obviously, the Basle Capital Accord could be revised to allow the decennial review currently under way to be an occasion for making capital requirements on lending to a country a function of IMF assessments of that country's compliance with the relevant international standards. The United States has effectively made adherence to its guidelines for comprehensive consolidated bank supervision by

23. Recall that the US Commerce Department has successfully spun off the Index of Leading Economic Indicators to the Conference Board. There is no reason why the Fund should not start with a similar strategy with respect to rating countries' compliance with standards and see whether it works.

24. While there are likely to be serious limitations, as emphasized in chapter 7, on the scope for preapproved (contingent) credit lines for countries with strong policies, to the extent that credit lines for such countries can in fact be preapproved, compliance with the relevant international financial standards is an obvious criterion for the Fund to use when deciding who qualifies.

home-country supervisors a condition for approving a foreign bank's application to establish a US office.[25] This precedent can be extended to other standards (besides comprehensive consolidated bank supervision) and adopted by other countries (indeed, coordinated across them).

Implications

Promoting the development of and compliance with standards for financial regulation, auditing and accounting, corporate governance, and insolvency law might seem like a radical departure for international financial institutions such as the IMF. In reality, the official community has already moved in this direction, notably in the activities of the Basle Committee but also in the efforts of the OECD to negotiate principles for corporate governance and of the United Nations to sketch a model bankruptcy code. The IMF is involved, having established a data dissemination standard for countries intending to access international capital markets and a code of fiscal (and, soon, monetary and financial) transparency. That governments and international organizations are being pushed into involvement in this area over their own protests is evidence that financial regulation, auditing and accounting, corporate governance, and insolvency law are too important to financial stability to ignore. It is evidence that the development and promulgation of international standards are the only practical way of addressing these problems.

Differences in economic, social, and legal traditions complicate the process of reaching agreement on standards, much less effectively enforcing them. Solutions to these problems will not be reached quickly. The danger is that they will never be reached if the IMF, the Basle Committee, and the rest of the international financial community do not rely more heavily on the private sector. The thousand-some economists of the IMF, even together with their colleagues at the World Bank and the BIS, lack the time and expertise to negotiate and implement international standards in the all the relevant areas in all 182 IMF member countries. They need rely on the IASC, IOSCO, Committee J of the International Bar Association, and their counterparts with expertise in other issue areas to develop the relevant standards. They then need to publish information on adoption and enforcement so that the markets can sanction countries that fail to comply. The G-7's and G-22's acknowledgment of the desirability of taking advantage of the expertise of IASC and IOSCO are small steps in the right direction. They now need to be followed up by more systematic and extensive collaboration between the public and private sectors.

25. Under the provisions of the Foreign Bank Supervision Act of 1992, as described in G-22 (1998b, 41). The G-22 concludes that this has at least marginally encouraged other countries to improve their supervisory systems.