Roundtable: Policies to Prevent Future Crises

Proposals and IMF Actions to Reduce the Frequency of Crises

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This conference has been largely about which lessons of past crises can be used for the prevention of future crises, something that I take to be important. A few months ago, Ned Phelps of Columbia wrote to the *Financial Times*, complaining that the International Monetary Fund was seeking to prevent crises, and stating that crises were a very healthy phenomenon, a way for the system to get rid of various inefficiencies. After a while, he sent me an e-mail asking why I had not replied to his letter. I responded that I had not replied in the *Financial Times* because I was certain that if I did, his answer would be "Aha, I caught you; you actually believed that I meant what I said."

In any case, many crises are unnecessary, preventable, and highly damaging. Our goal must be to prevent crises that arise because institutions are highly imperfect or because information is highly imperfect.

I will take up five topics, and will probably be mixing up a little what is happening in the IMF with what I believe ought to be happening in the international system to reduce the frequency of crises.

Exchange Rate Systems

First, exchange rate systems. It is an astonishing fact that all the massive crises of the past five years—the really big ones—have been associated with the collapse of formally fixed or quasi-fixed exchange rate systems: Mexico in 1994; the three Asian IMF program countries of Thailand, Indonesia, and Korea; Russia in 1998, in many ways the most

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consequential of the crises for the rest of the world; and Brazil in 1998 and 1999. These crises offer strong evidence about the role of exchange rate systems. The other piece of evidence is the crises that did not happen, for instance in Turkey, South Africa, and Israel—contries that were hard hit by contagion, but did not experience massive crises of a certain type.

What type of crisis is that? The sort in which, on a given day, the entire basis of policy for the past 5 or 10 years, and the entire set of assumptions on which the financial structure has been built, are wiped away. That type of crisis, with its unfortunate consequences, can probably be avoided by actively using flexible exchange rate systems.

One has to take note of the fact that the very hard pegs have succeeded, and the bipolar approach to exchange rates, peg very hard or float, does seem to be justified by what has happened in recent years. That view is consistent with the impossible trinity of a floating exchange rate, free capital mobility, and a monetary policy devoted to domestic goals. I believe the evidence points strongly to the bipolar conclusion, but there are sensible and influential economists who believe intermediate regimes can and should be maintained.

I should also note the extreme reluctance of some members of the IMF to move away from pegged exchange rate systems. A number of countries are operating with pegged rates in situations where more flexibility would be desirable. Typically we make the case you have just heard. They say, "Yes, next year we are going to open up the band a little." Then you arrive next year, and they are thinking about how difficult it is, because there is no interbank market, and so forth. I do not know what makes them so reluctant and so willing to court crisis. Somebody suggested to me that fragile societies do not like change, but not all the countries I am thinking of are fragile.

One other point: although the Asian crisis countries are still, Malaysia aside, formally floating, they are intervening to stabilize rates. Fortunately, they have not pegged formally, and they retain the exchange rate as a safety valve. However, the yearning is there for more exchange rate stability than is likely to be developed through a freely floating system, and so, those issues remain open in an important set of emerging market countries.

Transparency and Surveillance

Point two: transparency. This really is important. Transparency matters in two ways. We tend to emphasize the importance of having informed investors, but a second factor is equally important: the constraints that transparency puts on policymakers. Certain things that helped cause the Asian crisis, like the Thai central bank's commitments in the forward market, could not have occurred had adequate information been out there. Why would they not have happened? Well, the crisis would have happened much sooner, for one thing, and that means the crisis would not have been as deep as it was. Also, the commitments in the forward market would not have been made if the public had been informed. Transparency about what governments do is a constraint on policy, and transparency is also vital because it produces an informed set of investors. Of course, these aspects interact.

We are doing a great deal now to improve transparency, particularly through the creation of the Special Data Dissemination Standard (SDDS), an enhanced data set, which both emerging market and advanced countries subscribe to and are making publicly available. We have recently increased, by a large amount, the information on reserves that countries make available under the SDDS. The information was due by the end of May, 2000. Around June third, only 18 out of 47 countries had submitted it, and we feared this one had not worked. But somehow by June fifteenth we were up to 40 out of 47 countries, and by now virtually all 47 countries are publishing much better reserve data.

Just recently,[1] the IMF decided, following a pilot project, that member countries that want to publish their Article IV reports—the regular surveillance reports by the Staff—will be allowed to do so. That represents a major step forward in Fund transparency. In addition, we are publishing extraordinary amounts of information about other aspects of Fund activities. We even have accounts that are now understandable to mere mortals and that meet the International Accounting Standards. The discussion about efforts to increase transparency at the IMF and on the part of member countries will continue, but we are now making most information we have public—and that is a very good thing.

Standards and Codes for Financial Operations

Point three: standards and codes. You heard discussion earlier about the creation of the International Standards for Securities Commissions through IOSCO. A whole host of standards and codes have been issued, including the Basle core banking standards and various others, some of which the IMF produced.

Some developing countries are concerned that the industrialized world is ganging up on them and forcing them to move too fast to implement standards and codes. There should be no doubt that these standards are good for countries to meet. The issue is how fast standards should be adopted, what length of time should be given to make the adjustments and to make sure that the adjustments are done well. These standards are the essential foundation for building a modern economy

[1] This sentence has been updated to reflect developments since June, 2000.

that is integrated into the world economy. The changes will happen, but gradually.

The Role of Reserves

Point four: reserves. It is striking, and still a matter of some interest, that countries that had very high reserves have done much better in withstanding external financial pressures than those with smaller reserves. Why is it that even countries with flexible exchange rates seem to benefit from having very large reserves? And why has the indicator, reserves over short-term debt, worked so well as one of the best single predictors of crisis? At least one major country has also drawn the conclusion that the level of reserves matters. Korea, two months before the crisis in 1997, had about $35 billion in reserves. Two months later, reserves were down to zero, and today they are up to $89 billion. They seem to be aiming for $100 billion. Quite likely, when they get to 100, they will aim higher.

Given that reserves seem to matter so much, the possibility of providing precautionary lines of credit by the IMF or by the private sector is well worth pursuing. Holding reserves is very expensive for most emerging market countries: The gap between what the country pays to borrow them and the return on holding them is typically several hundred basis points.

The "contingent credit line" facility (CCL) developed by the IMF would make lines of credit available to countries that have good macroeconomic policies and meet certain standards in banking, statistics, and so on. Such credit lines could greatly reduce the costs of having this reserves cushion. We introduced the CCL in 1999. There have been no takers so far, but the design of the CCL has recently been improved, to make it more usable.

Assessments of National Financial Sectors

A fifth point is financial sector assessments. Apparently Thomas Jefferson once said that banking establishments are more dangerous than standing armies. We have seen it in these various crises. A massive attempt is now under way to strengthen financial systems. Together with the World Bank, and with central banks and supervisory agencies, the IMF is making it possible for member countries of the international institutions to have a so-called financial sector assessment.

A large and sophisticated World Bank–IMF team, including also experts from national agencies, does a comprehensive report on the strengths and weaknesses of the financial sector in the country. These assessments are voluntary, but the demand for them has increased significantly. They are very good. Some countries, like Canada, asked for a financial sector assessment early—probably, and helpfully, to provide a good example. Well, they got an A+. Hong Kong has also had a financial sector assessment. Other countries have also had assessments, probably because they genuinely want to know what is happening in their financial sectors, as assessed against the international standards.

Assessments are being done in some countries that have very weak financial sectors, and in some that are strong. Iran has had one. Colombia has had one. It is a great program, and an important tool through which the international community can help prevent and mitigate crises.

I hope the discussion of these five topics will persuade you that much can be done, and much is being done—indeed more is being done—to help reduce the frequency and virulence of crises.