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Global Capital Flows: The Recent Report from the Financial Stability Forum

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I. Introduction

The third working group paper produced by the Financial Stability Forum (FSF)[1] (the primary subject matter of this article) is concerned with global capital flows. The FSF established the Working Group on Capital Flows in April 1999 to evaluate policies for the reduction of the risk to financial systems associated with the build-up of short-term external indebtedness.[2]

The report of this third Working Group (the "CF Report") was submitted to the FSF for discussion at its Singapore meeting in April 2000. The FSF welcomed and endorsed the recommendations of the report at that time. The report builds on the other initiatives taken forward by the FSF including the two other working group papers on Hedge Funds[3] and Offshore Financial Centres,[4] as well as the task force report on Implementation of Standards.[5] The FSF identified twelve *Key Standards for Sound Financial Systems* (from within its Compendium) on June 12, 2000, following the May 2000 Implementation Report.[6] The FSF also issued a further paper on *International Guidance on Deposit Insurance* on June 26, 2000.[7]

The immediate need and focus of the CF Report is on the lessons that can be drawn from the difficulties experienced in Asia and elsewhere, especially with regard to the identification and management of capital flows. The report can then be seen as part of the continuing process of post-crisis reflection and review. Post-war financial markets have, however, been dominated by increased capital mobility more generally (either under managed or floating currency conditions). The report is then also important in attempting to take forward some (but only some) of the more fundamental problems that full capital mobility entails.[8]

1. The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. Mr. Andrew Crockett, General Manager of the Bank for International Settlements (BIS), was appointed Chairman of the FSF in his personal capacity for a term of three years. Support for FSF is provided by a small secretariat located at the BIS in Basel, Switzerland. For more information about the genesis and objectives of the FSF, see the Financial Stability Forum, *About FSF, at* http://www.fsforum.org/About/Home.html.
2. Financial Stability Forum, *Report of the Working Group on Capital Flows* (Apr. 5, 2000), at 8, *at* http://www.fsforum.org/Reports/RepCF.html. The Working Group on Capital Flows was chaired by Mr. Mario Draghi, Director General, Ministry of the Treasury, Italy.
3. *See* Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions* (Apr. 5, 2000), *at* http://www.fsforum.org/Reports/RepHLI.html.
4. *See* Financial Stability Forum, *Report of the Working Group on Offshore Financial Centres* (Apr. 5, 2000), *at* http://www.fsforum.org/Reports/RepOFC.html.
5. *See* Financial Stability Forum, *Report of the Task Force on Implementation of Standards* (Mar. 15, 2000), *at* http://www.fsforum.org/Reports/RepIOS.html.
6. *See* Financial Stability Forum, *Report of the Follow-Up Group on Incentives to Foster Implementation of Standards* (Aug. 31, 2000), *at* http://www.fsforum.org/Reports/RepInFoIS.html.
7. *See* Financial Stability Forum, *International Guidance on Deposit Insurance: A Consultative Process* (June 2000), *at* http://www.fsforum.org/Reports/RepIGDI.html.
8. *See Report of the Working Group on Capital Flows, supra* note 2.

Many of the changes that have occurred in the international financial system over recent decades have been driven by growth in private international capital flows.[9] The collapse of the Bretton Woods managed exchange rate system in the early 1970s was to a large extent caused by pressures created by increased capital mobility. Conversely, many of the difficulties experienced by emerging economies during the 1980s and 1990s were capital related, or at least aggravated by uncontrolled capital flows.

The Bretton Woods system itself was inspired by the goals to avoid protectionism and to promote international monetary co-operation and trade, employment and growth, and exchange rate stability consistent with these goals. The IMF historically has promoted full currency convertibility while it has less directly supported capital account liberalisation.[10]

More recently, the power of capital flows has become even more significant with the further advances that have been experienced in telecommunications, computer hardware and software support, and the creation of a new integrated and fundamentally interconnected (and interdependent) international financial marketplace. Much of this was originally driven by the early growth in the emerging euro syndicated loan and bond markets and underlying interbank markets during the 1960s, 1970s, and early 1980s.[11] The more recent introduction of electronically linked stock markets and the development of twenty-four-hour securities trading from the late 1980s onward have further strengthened this integration process.[12] A new wave of global trading in equities and debt instruments is also now expected with the sudden emergence of a number of new alternative trading systems (or platforms), which may substantially replace many of the existing stock markets and investment exchanges across the world through efficiency and costs savings.[13]

Rather than attempt to fight this process, and in particular by imposing continued or new limits on capital movements, most countries have accepted the realities of the new global marketplace that has emerged. They have then attempted to develop and strengthen their economies to take full advantage of the new range of financial facilities available rather than close their economy off from the potential dangers created. The CF Report is, thus, important in attempting to reconsider some of the basic issues involved.

II. More about Capital Control Issues

Although capital controls were uncommon during the nineteenth century, they did act as a significant constraint on cross-border activity for much of the post-World War II period. Currency convertibility was finally restored in 1958, although many countries continued to maintain capital restrictions until well into the 1980s and beyond. The most

9. Stanley Fischer, *Managing the International Monetary System*, Speech at the International Law Association Biennial Conference, London (July 26, 2000).
10. *Id.*
11. *Cf.* Zhaohui Chen & Mohsin S. Khan, *Patterns of Capital Flows to Emerging Markets: A Theoretical Perspective*, IMF Working Paper WP/97/13 (Jan. 1997), *at* http://www.imf.org/external/pubs/ft/wp/wp9713.pdf.
12. *Id.*
13. *Id.*

recent wave of capital account liberalisation began in 1979, with the United Kingdom's decision to abandon all controls under Margaret Thatcher with Japan following suit in 1980.[14]

A. IMF Article I

While the IMF has always supported the longer-term liberalisation of capital movements, it has had no formal authority in this regard since its establishment in 1944. It is clear from its original Articles and the Bretton Woods *travaux preparatoire* that capital controls were not to be included within its competence. Even with the 1978 amendments, member countries had only to undertake to avoid competitive devaluations, erratic disruptions and generally to promote orderly economic growth and price stability. The new Article IV surveillance mechanism was introduced but Article I of the Charter was not revised to add capital liberalisation to its core objectives.[15]

The issue was reconsidered in late 1997 and 1998, and the Board initially agreed to a draft amendment to Article I in advance of the Interim Committee meeting in April. Any further consideration of the issue was, however, abandoned with the advent of the Asian crisis. Making capital liberalisation an express purpose of the IMF is still mentioned in Washington, although it is unlikely that any substantial progress will be possible in this area in the near future.[16]

B. OECD Capital Code

In contrast with the IMF, the OECD has always had capital controls within its core mandate. The OECD has been concerned to promote sustainable growth and efficiency and the liberalisation of trade in goods and services and movement of capital between member countries.[17] For this purpose, the OECD issued its Code of Liberalisation of Capital Movements in December 1961[18] (along with its Code of Current Invisible Operations[19]).[20] Under the Code, members had to notify the OECD of any existing capital

14. *See* Pierre Poret of the OECD, *The Experience of the OECD with the Code of Liberalisation of Capital Movements*, presented in May 1998 at the IMF Seminar on Current Legal Issues Affecting Central Banks.
15. *See* International Monetary Fund, *Report of the Managing Director to the International Monetary and Financial Committee on Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF* (Sept. 19, 2000) [hereinafter International Monetary Fund].
16. *Id.; see also* IMF Staff, *IMF Reform: Change and Continuity* (Apr. 12, 2000), *at* http://www.imf.org/external/np/exr/ib/2000/041200a.htm.
17. *See* Pierre Poret of the OECD, *supra* note 14.
18. *Code of Liberalisation of Capital Movements, at* http://www.oecd.org/daf/investment/legal-instruments/clcmart.htm (containing the full text).
19. *Code of Liberalisation of Current Invisible Operations, at* http://www.oecd.org/daf/investment/legal-instruments/clioart.htm (containing the full text).
20. The Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations constitute legally binding rules, stipulating progressive, non-discriminatory liberalisation of capital movements, the right of establishment and current

controls, apply such measures without discrimination between member countries, liberalise certain listed operations (unless a reservation was lodged), and not introduce any new restrictions. A "ratchet" was effectively created with regard to all positive liberalisation steps. Members are obliged to give the Code full effects as a binding decision of the OECD.[21]

While the Code originally only applied to the disposal of (what was referred to as) non-resident blocked funds and free transfers for inward investment purposes, this was extended to apply to direct investment, long-term securities and credit operations, and personal capital transfers in 1964 and then rights of establishment of direct investors in 1984 and short-term capital movements in 1989 (including money-market transactions, forward market operations, and financial derivatives).[22]

It had been decided that short-term flows (even those referred to as "hot money") should not be included as part of the first reform back in 1964, on the basis that these might damage economic independence through unwarranted balance of payment shifts which could, in turn, undermine country commitment to the Bretton Woods fixed (but managed) exchange rate policy.[23]

By 1980, this policy had been completely reversed and following the United Kingdom's lead, all major substantive controls on capital movements were removed within OECD countries by the beginning of the 1990s.[24] Countries were then anxious to participate in the new deregulated and globalised international financial marketplace and ensure that their domestic financial industries could benefit from the high levels of innovation available. They were also anxious to strengthen their commitment to sound monetary policy and to encourage longer-term investment at the same time as it was simply recognised that capital controls had become disproportionately costly to administer regarding their supposed (nominal) benefits.[25]

C. Capital Policy

The dominant philosophy at the present time is, accordingly, that capital mobility should be actively encouraged (and not just tolerated) and that capital controls should be removed, except where domestic conditions would require otherwise. That is

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invisible transactions (mostly services). The Codes have been improved on various occasions since their initial adoption in 1961; important recent additions were the right of establishment (1986) and cross-border financial services (1992). The last Revision of the Codes expanding liberalisation obligations was undertaken in February 1992. Virtually all capital movements are now covered by the Capital Movements Code. Similarly, the sectoral coverage of the Current Invisibles Code has been progressively broadened to provide for unrestricted cross-border provision of an ever-greater range of services. The February 1992 Revision, in particular, introduced extensive new liberalisation obligations concerning the provision of banking and financial services on a cross-border basis and through branching.

21. *See* Article 5(a) of the Convention on the Organisation for Economic Co-operation and Development (Dec. 14, 1960).
22. *Cf.* Pierre Poret of the OECD, *supra* note 14.
23. *Id.*
24. *Id.*
25. *Id.*

not, however, to say that all countries including emerging or less developed economies should abolish their residual controls immediately. It is now generally recognised that such controls can only be removed when the economy and underlying financial system are sufficiently strong to deal with the new vulnerabilities created by capital outflows and inflows generated. While the benefits of capital mobility are now recognised, this "sequencing" of their application or implementation must be carefully considered. The IMF and G7 now refer to "the orderly, gradual and well-sequenced" liberalisation of capital accounts.[26] It is for this reason that the Working Group's report is particularly timely and can hopefully be of some assistance in allowing debtor and creditor nations and indigenous and foreign financial institutions to better identify and manage the risks involved.

D. Capital Value

The relative advantages and disadvantages of capital liberalisation as a core policy objective were recently reconsidered in an important policy paper by Barry Eichengreen and an IMF appointed research team.[27]

For the purposes of the report, capital account liberalisation is understood to refer to the freeing of transactions on capital outflows (including residents' purchases of foreign assets and repayment of foreign loans) and inflows (including foreigners' investments in local markets and property and loans to national residents). Capital may then take the form of debt, portfolio equity, and direct as well as real estate investment.

The basic theory is that international capital mobility should allow countries to attract foreign financing, facilitate greater investment portfolio diversification, and permit a better spread of investment risk as well as promote forward trading (sometimes referred to as inter-temporal trading, which involved trading goods today for goods in the future). Less extreme business cycles may result from redirected borrowing and investment overseas. Vulnerability to local economic disruptions may also improve risk-adjusted rates of return, which can, in turn, improve domestic savings and growth.

Against these "efficient markets" based arguments, however, a number of information difficulties might arise due to the fact that financial markets are inherently asymmetric (with one party always having more (or more accurate) information than the other). Particular problems can then arise with regard to adverse selection (inappropriate pricing or investment), moral hazard (reduced incentive to manage risk), and herding (parallel behaviour).[28]

The other main difficulty that arises with regard to capital liberalisation is, of course, sequencing or timing (which has been referred to above). While capital account liberalisation may not cause a crisis as such, it can magnify the effects of existing inadequacies in many areas of market operation and control. The sudden withdrawal of short-dated financing will then further aggravate instability and potentially generate an eventual collapse.[29]

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26. *See* International Monetary Fund, *supra* note 15.
27. *See* Barry Eichengreen et al., *Liberalizing Capital Movements: Some Analytical Issues*, Economic Issues of the IMF (No. 17) (Aug. 4, 2000).
28. *Id.*
29. *Id.*

These difficulties may be particularly serious where domestic operators have used overseas financing to support high-risk ("go for broke") policies (also referred to as "gambling for redemption"). They will then be even more savagely penalised as interest rates are raised to try to protect the value of a falling currency in light of further impending capital withdrawals. The crisis in domestic market confidence and currency instability will then mutually reinforce each other.[30]

It is against these dangers and the background of recent crises that have unfolded that the report has to be considered.

III. The Capital Flows Report

A. The Report in General

In its CF Report, the Working Group considers the nature of the risks associated with capital flows, especially having regard to the recent crises in emerging market economies. The specific national policy measures or international regulations that may bias capital flows towards volatility and risk are highlighted. The monitoring and management of risk at the national and bank sector level are then discussed. The relative costs and benefits of direct controls and capital flows are examined and the various types of institution-building measures that can be adopted to promote effective risk management identified.[31] Data collection and provision is considered separately.[32]

The Working Group notes that global capital mobility continues to be essential to support the efficient, cross-country allocation of financial resources and risk. A strong and safe system of global capital flows, however, requires well-functioning, competitive markets that accurately respond to proper price signals. Provided that these operate properly, external capital can be used to finance continued economic growth and development in all parts of the world.[33]

These advantages are not, however, without cost. Abrupt portfolio adjustments can halt or reverse capital flows and cause sharp changes in asset prices. Concentrations of short-term debt can also increase the risk of crisis, which can lead to significant systemic consequences. The Asian crisis clearly demonstrated that currencies with fixed exchange rates and large amounts of short-term maturing debt were prone to disruptive volatility where liquidity and related risks were not properly managed.[34]

Such instability could also be aggravated by national programmes that limit long-term external borrowing by residents or encourage short-term lending by international banks. Accordingly, excessive concentrations of short-term maturities had to be avoided to limit the high levels of rollover risk and increased volatility they generated.[35]

30. *Id.*
31. *See Report of the Working Group on Capital Flows, supra* note 2.
32. *Id.* ch. V (data on external financial positions).
33. *See* William R. White, *Recent Initiatives to Improve the Regulation and Supervision of Private Capital Flows*, BIS Working Papers (No. 92) (Oct. 2000).
34. *Cf.* Pierre Poret, *Liberalising Capital Flows: Lessons from Asia*, OECD Observer No. 214 (Oct./Nov. 1998).
35. *See Report of the Working Group on Capital Flows, supra* note 2, at 10.

In addition to these immediate corrective policies, the Working Group considered that a proper capital risk flow management framework had to be constructed. The purpose of the CF Report then became an attempt to construct such a framework based on identifiable stocks of assets and liabilities within a particular country. The objective was to recognise the existence of such risks but attempt to develop appropriate means to monitor and manage them.[36]

The Working Group then makes six sets of recommendations based on better national risk monitoring supported by improved risk management by public bodies, the banking sector and other financial institutions as well as enhanced transparency and data collection and provision.[37]

B. Key Elements of the Report

The key elements of the report are based upon proper risk identification, measurement, and management. This builds on the other initiatives currently under way in connection with market transparency with full, timely, and accurate data provision and dissemination. The report then takes this forward by attempting to construct a new management framework in the area of capital flow risk.

1. *National Risk Monitoring*

The Working Group considers that national authorities should have as a clear goal a risk management strategy that involves a system for monitoring and assessing the risks and liquidity of the economy as a whole including sector exposures. Such an assessment is critical at times of crisis although the same information could also be used to avoid crisis occurring in the first place.

Risk monitoring at the national level could be assisted by compiling a balance sheet for the economy as a whole, as well as its key sectors. This should be designed to identify significant exposures to liquidity, exchange rates, and other risks.

National authorities, as well as international bodies, would then be able to assess the possible adverse consequences of policies in terms of creating biases towards short-term capital flows or otherwise encouraging a build-up of unwarranted external exposures. "Prompt corrective measures" would be required wherever any specific vulnerabilities are identified.[38]

36. *Id.* at 12. By focusing on the risk exposures of various kinds of market participants, it highlights the risk management problems that need to be addressed if the potential benefits of capital flows are to be realised. Such a framework also helps to highlight the need for greater transparency and for certain kinds of data that will allow better risk assessment and management on the part of both creditors and debtors.
37. *See* Tables 1 to 6 appended hereto.
38. *See* Table 1(c) appended hereto.

2. *Improved Risk Management*

The following aspects of improved risk management are discussed in the CF Report:

a. Public Bodies

Governments should limit the build-up of liquidity exposures and other risks that made their economies vulnerable to external shocks. Sound risk management by the public sector is essential. To assist national authorities understand and implement more systematic risk management procedures, the Working Group recommends that operational guidelines, or sound practices, be formulated for liquidity management and asset and liability management more generally.[39]

The IMF and the World Bank should also develop guidelines for sound practice in sovereign debt and liquidity management drawing on national experts including members of the Working Group. National authorities should then be encouraged to develop their capacity for risk management and to implement sound risk management policies.[40]

A number of factors are identified in the report in connection with the management of official foreign currency reserves. The domestic bond markets should also be developed to assist governments in avoiding the concentration of borrowing in short maturities or in foreign currencies and to create diversified portfolio strategies with more dispersed maturity.

b. Banks

The Working Group considered that banks in countries receiving capital inflows and, in particular, emerging market economies and international banks that extend cross-border credit both had a responsibility to avoid any build-up of exposures that generate systemic vulnerability.[41]

The recent publication of the Basel Committee's revised guidelines on managing liquidity risk was welcomed (especially with regard to the distinction drawn between domestic and foreign currencies), and their application to emerging market economies was given priority.[42] Further guidance from the Basel Committee on how to measure and manage foreign exchange exposures was also thought desirable. More work also should be done by the Basel Committee to consider the linkages between liquidity risk, foreign exchange risk, and credit risk.[43]

The Working Group welcomed the Basel Committee changes to the system for determining risk weights for sovereign and private credits and the risk weights that currently favour short-term interbank claims.[44]

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39. A separate checklist of issues had been prepared by the Working Group, which such guidelines should cover. For a detailed sovereign risk management checklist for national authorities, see *Report of the Working Group on Capital Flows, supra* note 2, at 24.
40. *See* Table 2 appended hereto.
41. *See Report of the Working Group on Capital Flows, supra* note 2, at 27.
42. *See* Basel Committee on Banking Supervision, *Sound Practices for Managing Liquidity in Banking Organisations* (Feb. 2000).
43. *See Report of the Working Group on Capital Flows, supra* note 2, at 28.
44. *Id.*

c. Other Financial Institutions

The Working Group recommended that IOSCO and the IAIS should also continue to promote prudent behaviour on the part of securities firms and insurance companies, especially insofar as the issues raised in the report with respect to banks also apply to these other financial intermediaries. This should be supported by efforts by national authorities to promote good corporate governance practices.[45]

3. *Enhanced Transparency*

Good information was considered fundamental to risk management and disclosure by participants in financial markets. National authorities accordingly should adopt a high level of transparency concerning their own risk and liquidity management strategies and operations and about official regulatory policies governing private sector risk and liquidity management. Agencies responsible for financial stability should also aim to publish an annual assessment of liquidity conditions in the economy as a whole and in important sectors of the economy, in particular, the banking sector and other parts of the financial sector. The adoption of effective accounting standards also had to be secured at the national level.[46]

4. *Data Collection and Provision*

Better data on aggregate external financial positions was required if investors and borrowers were to understand more fully and take better account of the risks inherent in international capital flows. The Working Group accordingly proposed that a conference be held to promote the availability and quality of data and, in particular, enhanced reporting of external flows and positions.[47]

A conference on *Capital Flow and Debt Statistics: Can We Get Better Data Faster?* was then hosted by the IMF on February 23–24, 2000, in Washington, D.C.[48] Almost 120 senior-level data users, policy makers, and compilers attended. The discussions focused on the actions and resources required to provide better and timelier data on capital flows and possible policy priorities. While some progress was achieved in identifying the issues involved and in understanding their respective positions, there appeared to be no consensus between data users and compilers on the priorities to be followed. A number of differences of opinion had arisen, especially with regard to national statistical priorities and resources, compilation difficulties, and respondent burden. Further work will clearly have to be taken in this area.

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45. *Id.* at 34.
46. *See* Table 5 appended hereto.
47. *See* Table 6 appended hereto. The CF Report says that key initiatives to improve data dissemination include steps to enhance the Special Data Dissemination Standard (SDDS), the work of the Inter-Agency Task Force on Finance Statistics (TEES) on a new guide for external debt statistics, and efforts to improve the dissemination of creditor and market data.
48. *See* International Monetary Fund, *Conference on Capital Flow and Debt Statistics: Can We Get Better Data Faster?*, Background Paper of the IMF, Feb. 23–24, 2000, *at* http://www.imf.org/external/pubs/ft/seminar/2000/capflows/bg.htm; *see also* International Monetary Fund, *Summary of Proceedings of the Conference on Capital Flow and Debt Statistics: Can We Get Better Data Faster?*, *at* http://www.imf.org/external/pubs/ft/seminar/2000/capflows/summary.htm.

In the CF Report, the Working Group also accepts that progress had been made in upgrading the quality, coverage, and timeliness of data on external flows and positions. A number of gaps, however, still existed with further gaps arising with continued innovation in product design.[49]

The Working Group identified a number of other areas where efforts were required at the national level to enhance the disseminated data required to assess the risks and liquidity of the economy. While some of the recommendations contained in the report are already being acted on, further work is necessary in a number of areas identified.[50]

IV. Concluding Observations

Although more restricted in scope and possibly of less immediate excitement or interest in terms of the issues considered than the other FSF working group, the CF Report is still a useful document that should be welcomed. While some of the recommendations are somewhat obvious and arguably simply repetitive of the other papers, the core risk management policy and the basic monitoring framework proposed are useful initiatives. The Working Group also clearly appreciates that it cannot develop the new framework by itself without further work having to be undertaken partly through the IMF and other sector committees, including the Basel Liaison Group, but also with a necessary degree of national support. Though some work has been undertaken in this regard, it is regrettable that more progress was not possible at the joint IMF/Working Group conference on the collection and production of better and faster capital flow data.

Although not referred to as such, the framework proposed almost takes the form of an early warning system for international financial crisis. The design and development of an appropriate early warning system had been assigned to the Basel Committee at the time of its establishment in 1974. This was referred to in the press releases and newspaper commentaries at the time. Following early Committee meetings, however, Sir George Blunden reported that the Committee had concluded that it had not been possible to agree on setting up any form of effective system in this regard. Following the Asian crisis, there have then been further calls for the development of such a system although no clear proposals have yet emerged. It may be that the capital flow framework proposed by the Working Group could be developed into or possibly, at least, form part of such a system.[51]

The two main omissions from the report are foreign currency risk management and crisis control. Although foreign exchange controls were also within the original mandate of the Basel Committee at the time of its establishment, many of the relevant issues especially in terms of settlement related matters have since been taken forward by the Committee on Payment and Settlement Systems (CPSS).[52] The Basel Committee

49. *See Report of the Working Group on Capital Flows, supra* note 2.

50. *Id.*

51. *See* forthcoming volume by the author in the Basel Committee (Kluwer International Publishers 2000).

52. *See* Committee on Payment and Settlement Systems (CPSS), *Current Topics in Payment and Settlements Systems,* Paper presented at a CPSS Asian-Pacific workshop, Hong Kong SAR (May 1999).

has, however, returned to some of these issues in more recent papers although further work is still required. Crisis management has also been dealt with in the various papers produced, for example, by the G10 or the G22 Working Groups post-Asia, although again no final set of complete nor coherent proposals have yet emerged.[53] These remain two key areas of significant potential exposure and work must continue to ensure that appropriate control mechanisms are set up in each case. It is disappointing that the Working Group did not spend more time on these issues nor attempt to build them into any larger control framework. It is possible that it was considered that these issues had already been dealt with adequately elsewhere or that they were simply outside its immediate terms of reference. These will, however, still have to be reconsidered as part of some overall risk identification and management structure.

To a large extent, the CF Report only then revisits some important areas of international global monetary and financial policy management, which have been known about and discussed for some time. The report is also fundamentally modest in its immediate ambitions and recommendations. To this extent, it adds little to larger policy formulation. Nevertheless, it is important in beginning to bring forward some of the more technical information and data-related issues in an informed and co-operative manner and should be welcomed for that reason.

The main issue, however, remains the proper policy base for capital revision or capital reform and, in particular, the extent to which this can be pursued as a final goal or cold policy objective in its own right or only as part of some larger revision programme.

From the difficulties that occurred in Asia (including Thailand and elsewhere), sequencing is clearly a critical issue. Full capital account liberalisation should only be considered when countries have achieved the requisite degree of financial stability and development to ensure that they can withstand the economic pressures that arise where there is any significant withdrawal of foreign investment. It must be accepted, however, that it will always be extremely difficult to determine when this may or may not be appropriate and, if not, it is unclear what other policy options may be available. Sequencing is then part of the solution, but only one part.[54]

Rather than question the desirability and timing of capital liberalisation, especially in terms of its relative advantage and disadvantage, it might be more useful simply to assume that it is an inevitable fact of the modern financial world. The question then becomes not whether or when we should do something but simply what can we do.

The initial issue to be considered must always be information. While the intricacies of statistical data definition, classification, collection and measurement as well as its subsequent dissemination, may not command the most immediate attention or attract the highest interest, it is impossible to prepare any considered response until we know exactly what we are dealing with. One of the most significant contributing factors to the Asian crisis was the lack of timely and accurate information concerning country

53. *See, e.g.*, Basel Committee on Banking Supervision, *Supervisory Lessons to be Drawn from the Asian Crisis*, Working Paper (June 1999); Basel Committee on Banking Supervision, *Principles for the Management of Credit Risk* (Sept. 2000); Basel Committee on Banking Supervision, *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions* (Sept. 2000).

54. *See* Eichengreen et al., *supra* note 27.

debt and reserves positions. Data provision is then crucial to any immediate monitoring activity as well as to the construction of any larger policy response. Whether a country has adopted a liberated capital policy or not, relevant exposures must be measured and monitored, which can only be achieved with full and timely technical data production.

While this might be seen as part of the larger initiatives currently under development at the international level with regard to transparency and disclosure and especially with the IMF's highly valuable SDDS and GDDS work (which is now regularly updated on its Standards Bulletin Board),[55] it is impossible to disclose anything until it has initially been obtained. Data transparency must assume data availability, although it is clear from some of the work undertaken to date that this might not always be as simple as it might appear. The Working Group should be commended to the extent that it has assisted in this process in some way.

In terms of risk and crisis prevention or containment, two further sets of issues should be considered with regard to systems sufficiency and possible direct transaction control.

The stability of any underlying financial system must be strengthened. This will depend upon each of the policies being followed that have been identified in all of the post-Asian crisis new architecture papers. Sound macroeconomic polices must initially be adopted. Then, the financial system must be strengthened through the implementation of appropriate measures in all of the areas identified by the IMF, the FSF, and other policy bodies. This will include financial sector reform (banking, securities, and insurance), corporate governance, payment and settlement, and audit and accountancy requirements. Relevant international standards in each of these areas must be given full effect or, at least, equivalent effect (in terms of the scope and degree of protection provided, depending on local market and legal structures).

In addition to these more indirect (and essentially supportive) measures, consideration should then be given to the possibility of introducing some form of direct transaction controls in appropriate cases. The objective would be to limit the types of financing arrangements that may create or aggravate vulnerabilities and, in particular, the excessive use of short-duration foreign currency call facilities. A number of the recommendations of the Working Group are directed at these types of transactions, although the report does not develop the possible control options available. These might, for example, include outright prohibitions on certain transactions (although this would be highly undesirable as it would limit contractual freedom and possibly obstruct the use of certain arrangements which would be appropriate or necessary in connection with certain (limited) investment projects). Of more potential value might be higher capital charging, which would impose a cost on the transaction that could (at least in theory) be calibrated to the potential additional risk created (although care must always be taken not to rely too much on capital regulation due to the inherent limitations of capital controls). Alternatively, some form of reserve or deposit requirement or even a direct

55. On March 29, 2000, the Executive Board of the IMF conducted its third review of the Fund's Data Standards Initiatives, covering both the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS). The paper prepared for the Board discussion and the results of the Board discussion are both currently available at http://www.imf.org/external/np/sta/dsbb/2000/index.htm and http://www.imf.org/external/np/sec/pn/2000/PN0031.htm.

tax charge could be applied (but only as a last resort). The objective in each case would be to create appropriate financial disincentives to the use of certain types of higher risk facilities.

While the introduction of some flat contractual prohibitions or direct taxing would both be highly undesirable, the possible use of some other disincentive device should be given further consideration. This would limit the development of potential sources of instability through the use of such transactions at a time when countries are trying to strengthen their monetary and financial systems and improve the volume and quality of the information made available to potential investors through the international capital markets.

The longer-term solution may be that a combination of enhanced transparency, standards implementation, and incentive mechanisms is necessary rather than any single corrective device on its own. Capital reform will then not be an end in itself but only one part of a larger reform process, which all countries should consider to allow them to participate fully in the new global markets of the third millennium. Maybe this is the main lesson to be learned from all of the recent work carried out in this area and reflected in the CF Report.

Appendix: Principal Recommendations of the CF Report

TABLE 1 **Risk monitoring at the national level**

(a)	National authorities should have, as a clear goal, a risk management strategy that involves a system for monitoring and assessing the risks and liquidity of the economy as a whole including at a sectoral level. Such an assessment is critical at times of crisis although the information should also be used to avoid crisis.
(b)	Risk monitoring at the national level could be assisted by compiling a balance sheet for the economy as a whole and for key sectors which is designed to identify significant exposures to liquidity, exchange rates and other risks. The authorities should employ simple vulnerability indicators and more sophisticated stress tests and scenario analyses in assessing the potential impact on liquidity and balance sheet strength of different types of shocks to the real or financial economy.
(c)	National authorities, as well as international bodies, should assess the possible adverse consequences of policies in terms of creating biases towards short-term capital flows or otherwise encouraging a build-up of unwarranted external exposures and should take prompt corrective measures.

TABLE 2 **Risk management by the public sector**

(d) Recent experience has highlighted the need for governments to limit the build-up of liquidity exposures and other risks that make their economies vulnerable to external shocks. For this purpose, sound risk management by the public sector requires high priority. This is prerequisite for risk management by other sectors, as individual entities within the private sector typically are faced with significant problems when inadequate sovereign risk management generates vulnerability to a liquidity crisis. To assist national authorities understand and implement more systematic risk management procedures, the Working Group recommends that operational guidelines, or sound practices, be formulated for liquidity management and asset and liability management more generally. A separate checklist of issues has been prepared by the Working Group, which such guidelines should cover.

(e) The IMF and the World Bank should develop guidelines for sound practice in sovereign debt and liquidity management drawing on national experts including members of the Working Group. Three closely inter-related elements should be examined with a view to distilling a set of sound debt management guidelines. National authorities are to be encouraged to develop their capacity for risk management and to implement sound risk management policies.

(f) In connection with the management of official foreign currency reserves, the Working Group stressed the following factors:

- (i) More official reserves are required when a country operates a fixed exchange rate regime it has a low standing in and access to international capital markets and its public sector external or foreign currency liabilities are of a short duration;
- (ii) While prudent liquidity management by banks and effective regulatory oversight must be the primary defences against foreign currency liquidity problems in the banking sector, the public sector should take account of such risks in its own reserves policy as it might otherwise find itself unable to supply needed foreign currency liquidity to the banking sector to contain an incipient crisis;
- (iii) Policy on official reserves and foreign currency liability management should also place weight on the position of the non-bank private sector although the primary mechanism for effective risk control should be improved transparency.

(g) The domestic bond market should be developed to assist governments to avoid concentrating borrowing in short maturities or in foreign currencies and to create diversified portfolio strategies with more dispersed maturity.

(h) International institutions should assist countries to identify elements of public sector risk management that deserve attention and to monitor and encourage progress in implementing those policies. Technical assistance should be provided where required by international institutions and national authorities.

TABLE 3 **Risk management by the banking sector**

(i) Both banks in countries receiving capital inflows and, in particular, emerging market economies and international banks that extend cross-border credit have a responsibility to avoid any build-up of exposures that generate systemic vulnerability.

(j) The recent publication of the Basel Committee's revised guidelines on managing liquidity risk were welcomed (especially with regard to the distinction drawn between domestic and foreign currencies) and their application to emerging market economies should be given priority. Further guidance from the Basel Committee was desirable on how to measure and manage foreign exchange exposures. Until supervisory capacity is adequate, a set of more explicit regulations designed to limit liquidity and foreign exchange risks should be considered. The Working Group recommended that the Basel Committee's Core Principles Liaison Group and its Risk Management Group address issues related to currency and maturity mismatches in emerging market economies.

(k) More work should be done by the Basel Committee to consider the linkages between liquidity risk, foreign exchange risk and credit risk.

(l) With regard to credit risk, not all countries have the supervisory capacity to implement in full or immediately the new capital adequacy framework being developed by the Basel Committee. Such countries should be encouraged to enhance their supervisory procedures and be supported in these efforts. The Core Principles Liaison Group should be encouraged to develop recommendations as to how the new capital accord could apply to emerging market economies.

(m) The Working Group welcomed the Basel Committee changes to the system for determining risk weights for sovereign and private credits and in the risk weights that currently favour short-term interbank claims.

(n) National authorities should attempt to obtain sufficient information to assess the risk exposures to form currency funding of individual banks but also to monitor, through analysis of aggregated information, the overall exposure of the banking system to the risks of foreign currency funding.

TABLE 4 **Risk management by non-bank financial institutions and non-financial institutions**

(o) IOSCO and the IAIS should continue to promote prudent behaviour on the part of securities firms and insurance companies especially insofar as the issues raised in the Report with respect to banks applying to both other types of financial intermediary.

(p) National authorities should promote good corporate governance practices on the part of individual firms and government agencies should avoid policies that distort corporate sector liability choices and, in particular, that bias corporations to short-term borrowing.

TABLE 5 **Transparency**

(q) Good information is fundamental to risk management and disclosure by participants in financial markets a key element in making good information available.

(r) National authorities should adopt a high level of transparency concerning their own risk and liquidity management strategies and operations and about official including regulatory policies governing private sector risk and liquidity management.

(s) Agencies with a responsibility for financial stability should aim to publish an annual assessment of liquidity conditions in the economy as a whole and in important sectors of the economy, in particular, the banking sector and other parts of the financial sector. This should assist market participants and credit-rating agencies make more informed assessments about the liquidity of a country as well as increase the incentives for prudent debt and liquidity management.

(t) National authorities should promote, if necessary through corporate law, the adoption and implementation of accounting standards that require companies to disclose in their audited report and accounts the composition of their liabilities and financial assets including maturity and currency.

TABLE 6 **Data requirements**

(u) In addition to better disclosure of the financial positions and risk management policies of market participants, better data on aggregate external financial positions was required if investors and borrowers were to understand more fully and take better account of the risks inherent in international capital flows.

(v) To provide impetus in the process of improving the availability and quality of data, a conference was proposed in which policy makers involved in financial issues, officials in the statistical reporting function and representatives of the private sector should clarify the importance of enhanced reporting of external flows and positions and to explore priorities. [The IMF had hosted such a conference with the Working Group on 23–24 February 2000 in Washington.]

(w) Much progress had been made in recent years in upgrading the quality, coverage and timeliness of data on external flows and positions. Many gaps in available data had, however, still not been corrected with new gaps arising as further financial instruments became available that escaped the reporting net or transformed the risks associated with existing instruments in ways not captured by the available data.

(x) The Working Group identified gaps that it considered to be especially important, offering encouragement to efforts already underway to fill these and urge new efforts to assist deal with others. The Working Group, in particular, identified the following gaps with respect to statistics on external debt: data by residual maturity rather than original maturity; by face value as well as market value; with a distinction by currency as well as residency; information on embedded put options in bond contracts; and amortisation schedules (including interest payments).

(y) The Working Group urged relevant bodies to consider gaps with respect to creditor side and market data including: a cross-sectional breakdown in the Locational Banking Statistics that would enable a combined breakdown both by sector and maturity rather than just one or the other; reporting by offshore centres; private placements of debt securities held by the non-bank sector; data that might be available from global custodians; and non-resident purchases of domestically issued bond and money market instruments.

(z) The Working Group also identified a number of areas where efforts were required in the national context to enhance the determination of data that was needed to assess the risks and liquidity of the economy.