A Prague Scorecard

Barry Eichengreen
September 19, 2000

Finance ministers from around the world are meeting in Prague at a time of calm in international financial markets. The U.S. Federal Reserve has finished, for the time being, raising interest rates with the goal of cooling off the torrid American economy. As a result, the volatility that infected Wall Street this summer has subsided. Portfolio capital and direct foreign investment are flowing back to emerging markets. The world economy is poised to grow faster this year than it has in several decades.

There are still plenty of things to worry about. The U.S. current account deficit is large. The euro is weak. The prospects for the Japanese economy remain uncertain. Argentine unemployment is stuck at high levels, undermining support there for policies of austerity. It is always prudent to ask whether this is merely the calm before the storm. But the risks are surely less than they were two years ago at the time of Russia's default and the LTCM debacle, when George Soros was warning that global capitalism was "coming apart at the seams."

The gravest danger may be that these favorable conditions weaken the pressure for fundamental reform of the international financial system. The need for ambitious initiatives make the world a safer financial place seems less when everything is going so swimmingly. Hard choices are rarely taken in easy times.

Is the momentum for reform really petering out? The answer hinges on exactly what reform one is talking about.

With regard to crisis prevention, there is no sign that official efforts are losing steam.

Crisis-prevention initiatives center on the development of international standards for everything from data dissemination, monetary- and fiscal-policy transparency, bank supervision, securities market oversight, and insurance market regulation to auditing and accounting, bankruptcy and insolvency procedures, and corporate governance. The lesson drawn from the Asian crisis was that only countries that upgrade their practices in these areas will be safe from financial crises. And, given the tendency for financial problems to spill across borders and infect innocent bystanders, the world has in interest in seeing that all countries active on international financial markets strengthen their financial institutions and practices. International standards are designed to specify the necessary steps. They are a measuring rod for officials and investors seeking to rate countries' progress. Their existence allows multilateral institutions and markets to apply peer pressure to countries that are slow to comply.

In addition to the multilaterals, the standard-setting process involves organizations running the gamut from the International Accounting Standards Committee to the International Organization of Securities Commissions. Clicking on "Standards" on the IMF's website brings back a massive spreadsheet describing the areas in which standard-setting efforts are underway, the organizations involved, and the role of the IMF and its newly-appointed *aide-de-camp* in this campaign, the Financial Stability Forum in Basle. While much remains to be done, stronger institutions and practices will ultimately mean more stable financial markets and less crisis risk. The officials assembled at Prague can rightly pat themselves on the back for the progress they have made in this direction.

Crisis response is another matter. Here there has been only the appearance of progress, not the reality. Horst Koehler, the IMF's new Managing Director, announced in Prague that the

Fund will henceforth limit its conditions to the monetary, fiscal and financial issues that are its key concerns. But can the IMF really ignore prudential supervision when the stability of the international financial system hinges on how well countries regulate their banks? Can it ignore corruption when it is in the business of attempting to restore investor confidence? Can it ignore consequences of its advice for poverty and the distribution of income when it has to worry about the political sustainability of reforms? Simplifying IMF programs is easier said than done. One suspects that Mr. Koehler's "guidance note" to IMF staff will contain so many escape clauses and qualifications as to have no effect on actual practice.

The announcement last week that the IMF will charge higher interest rates and limit the duration of its loans is the official community's effort to discourage repeat borrowers from relying on the IMF for routine aid and to ensure that plenty of money is on hand when panic strikes. These changes, advocated by U.S. Treasury Secretary Summers, are designed to discourage countries from borrowing freely in order to pay off foreign investors when the latter rush for the exits. But will higher interest rates really deter borrowing by a government desperate to survive until the next election? The recommendation of the U.S. Council on Foreign Relations for a strict ceiling on the size of IMF loans would have been more effective. And will cutting the term of IMF standby loans by a year from the current term of 3 1/4-5 years, and of extended fund facilities from 10 years to seven years, really alter behavior? These "reforms" are much more modest than the strict 120-240 day limit recommended by the Meltzer Commission to the U.S. Congress.

Why more ambitious steps were not taken to limit IMF lending and address the "moral hazard" it creates is no mystery. IMF lending can be limited only if other ways are devised for responding to crises. The alternative to IMF bailouts is for countries experiencing a crisis to halt payments and restructure their debts -- that is, for the IMF to stand back and let events run their course. While the Fund was prepared to proceed this way in Ecuador, it is implausible that it will be prepared to do so the next time a crisis erupts in a large, systemically important country. Default and restructuring are painful and costly for the country involved and threaten the stability of the international financial system. This renders them unpalatable to the IMF.

The more widespread adoption of collective action clauses, which make provision for a bondholders assembly and allow a qualified majority to agree on restructuring terms, is the official community's main idea for how to solve this problem. Debt restructuring would then become more feasible than it is at present. By opening up an alternative route to resolving financial crises, the presence of collective action clauses would realistically allow the IMF to limit its lending, in turn dealing with the problem of investor moral hazard. But while the official community has mouthed the right words about the desirability of collective action clauses, it has done little to encourage their adoption. This is why it deserves a failing grade for its efforts to enhance crisis response.

Progress also remains disappointing in terms of reforming the governance of the international financial system. In the last 25 years, developing countries have been the exclusive target of IMF programs. The last advanced-industrial country to be the subject of an IMF program was the UK in 1976. But while the subjects of the IMF's tender ministrations are the low-income countries, the institution is still controlled by the high-income countries. That the subjects have so little voice in the Fund's decisions raises troubling questions about the institution's legitimacy. It leaves Indonesians who object to the conditions attached to the IMF's loans no way of expressing their views other than by burning tires in the streets.

Some progress has been made outside the Fund. The Group of 20 has been established as a more encompassing decision-making structure for overseeing the operation of the global financial system. It includes Argentina, Brazil, China, India, Indonesia, Mexico, South Korea and Turkey, along with the usual high-income countries, making it more representative than the G7 and the G10. The Financial Stability Forum includes Singapore and Hong Kong as full-fledged members, and its ad hoc technical committees include an even broader cross section of emerging markets.

But the IMF remains the key institution in this effort to make the world safe from financial crises. And representation there remains highly skewed. European countries continue to control a third of the IMF Executive Board's 24 seats, despite the fact that they are no longer the subject of Fund programs. African countries have a grand total of exactly two seats. No wonder they complain that IMF programs are poorly tailored to their needs and that they have inadequate say in the institution's decisions.

That Europe is so heavily represented in the IMF is an artefact of history that has outlived its usefulness. Once upon a time, exchange rate problems within Europe were a big part of the world's exchange rate problems. But now that Europe has a monetary union, there no longer can be exchange rate and balance of payments problems among its member states, any more than there can be exchange rate and balance of payments problems between California and New York. The traditional rationale for so many European seats on the IMF Board no longer exists. To put the point another way, if the 50 U.S. states require only one Executive Director, then what can possibly justify the fact that the 11 members of the euro area have six?

Europe has not exactly been a leader in efforts to strengthen the international financial architecture. It has not been a hotbed ideas for reforming the international financial system. As its contribution, it could at least donate some of its seats on the IMF board to under-represented emerging markets as a way of enhancing the legitimacy of the institution.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley.