

**THE EMERGING GLOBAL
FINANCIAL ARCHITECTURE AND ITS
IMPLICATIONS FOR INDIA**



MONTEK SINGH AHLUWALIA

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**INDIAN COUNCIL FOR RESEARCH ON
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Core-6A, Fourth Floor, India Habitat Centre,
Lodi Road, New Delhi-110 003
INDIA

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Foreword

What exactly is meant by the term global financial architecture and how does it impinge on India's efforts and ability to integrate financially with the rest of the world? There is an urgent need to answer these questions, particularly in the wake of the recent financial crises in South-East Asia, Brazil and Russia.

In the discussion paper "The Emerging Global Financial Architecture and its Implications for India", Montek Singh Ahluwalia presents the debate on global financial architecture and spells out its implications for policy making in India. The paper was presented at an ICRIER workshop where the participants included policymakers and representatives from the academia and the media. The presentation of the paper was followed by comments from Dr. Shankar Acharya who was the principal discussant. This was followed by a lively discussion amongst all the participants. Mr. N.K. Singh, Secretary, Prime Minister's Office, chaired the meeting.

The paper and the proceedings of the workshop are presented here with a view to creating a better understanding of the issues underlying the reshaping of global financial architecture.

Isher Judge Ahluwalia
Director & Chief Executive
ICRIER

Executive Summary of Discussion Paper

The 1990s have been characterised by financial crises which have been more frequent, more unpredictable and much more severe than in the past. The new financial architecture attempts to respond to this situation by identifying initiatives aimed at crisis prevention and crisis resolution.

Crisis Prevention

Six areas are viewed as critical for crisis prevention and it is interesting to see what implications they have for the Indian situation.

The Macro Fundamentals

Indicators of weak macro fundamentals are a large fiscal deficit, a high current account deficit especially with real exchange rate appreciation, heavy external indebtedness especially if there is large short term debt, slowing down of export growth performance, and excessive expansion in domestic credit. At present India looks weak only on the fiscal front.

Improved Information, Greater Transparency and Better Surveillance

Developing countries are especially vulnerable to crises because investors lack adequate information about these countries and this leads to wild swings from excessive optimism or euphoria to excessive gloom and panic. Improving the flow of information, and also the level of surveillance, is therefore regarded as an important aspect of crisis prevention. The International Monetary Fund (IMF) has developed its Special Data Dissemination Standard (SDDS) and codes of good practices in the fiscal and monetary accounts which will push countries to higher standards of transparency and disclosure in these areas.

There is general agreement that IMF surveillance must be strengthened as an instrument of crisis prevention, and a growing consensus that there should be greater public disclosure of the results of surveillance. There also seems to be some appreciation of the need to interact with the international rating agencies in assessing the economic performance of countries. The usefulness of regional surveillance, on the other hand, is doubtful. A structured official-private dialogue between government, on the one hand, and private creditors and investors, on the other, as in practice in Mexico, is also worth considering.

Strengthening the Financial System in Developing Countries

India began the process of reform in this area in 1991. The present position is that our prudential norms and standards in Indian banking have been greatly improved, but they still fall short of international standards in several respects.

However, the crucial task before us is how to strengthen the public sector banks to enable them to function efficiently in the more competitive environment they will face in future. We also need to upgrade standards in other areas of the financial sector such as insurance, the securities market, accounting standards, bankruptcy laws and corporate governance.

Strengthening the Financial System Internationally

There is a growing concern that the IMF, as part of its Article 4 surveillance and the World Bank as part of its country economic work, should cooperate to keep a close tab on the progress of financial sector reforms in the so called “systemically important” emerging market countries. Such countries, which includes India, are likely to be subjected to enhanced surveillance of the financial sector.

The G-7 have recently established the Financial Stability Forum (FSF) consisting of representatives of the G-7 governments and central banks, the IMF and the World Bank, the Basle Committee, the BIS, IOSCO and IAIS. The FSF will take an overview of the functioning of the international financial system as a whole and identify areas where gaps exist. No developing country has been included in the FSF thus far.

More recently, the G-7 have established a new Group of 20 which consists of the G-7 industrial countries plus some other systemically important developing countries to act as a forum for discussion of important issues in international finance. India is a member of this group. It remains to be seen how effective this group will be.

The Role of Capital Controls

Attitudes towards capital controls have changed considerably following the East Asian crises. The new conventional wisdom is that developing countries should be cautious in this area, liberalising gradually and in a carefully sequenced manner, *pari passu* with efforts to strengthen the financial sector. India comes out relatively well on this score because we have been cautious.

Given the importance of international capital flows in the world economy, and the fact that all developing countries including India are progressively opening up to international financial markets, it is something of an anomaly that the Fund has no mandate at all in this area. One can argue that there is a case for giving the Fund some sort of a mandate which would enable it to play a larger role in surveillance of restriction on capital transactions especially at times of stress.

Exchange Rate Regimes

The choice of exchange rate policy is a difficult issue. It is generally recognised that no country can simultaneously achieve all three objectives of stable

exchange rates, free capital movements and an independent monetary policy. It is necessary to give up at least one of these. International opinion has not crystallised unambiguously on how these choices should be made. It is accepted that in certain situations (e.g., a small country trading dominantly with one currency area) the authorities may be willing to abandon monetary independence in favour of exchange rate stability. However, it is unlikely that many countries will be willing to give up monetary independence and this points inevitably to greater exchange rate flexibility. However, exchange rate stability can be combined with an independent monetary policy if capital controls are in place. This is essentially the situation we face in India. As we loosen up on capital controls in future, we must be ready to accept greater exchange rate flexibility. It is therefore necessary to begin moulding public opinion towards this end.

Mechanisms for Crisis Resolution

There is much less agreement in this area than in crisis prevention. Developing countries feel that the process of integration with the international financial system exposes them to the risk of severe crises because of irrational behaviour caused by the inherent volatility of “uninformed” investor sentiment which is prone to fluctuate between euphoria and panic. Such panics when they occur need to be quelled by the availability of a credible international lender of last resort that can quickly provide a large volume of resources to deserving countries. It is argued that the IMF must be suitably strengthened to enable it to act as a lender of last resort for developing countries.

On the other hand, there is concern among developed countries, that a perception that public international institutions will be available to bail out countries in a crisis will only encourage moral hazard, i.e., imprudence on the part of borrowers as well as lenders. Use of public resources must therefore be sparing, associated with high conditionality to reduce moral hazard.

The Fund has introduced several innovations that enable it to play the role of crisis manager more effectively than in the past. But since we are not in a crisis, nor in any immediate danger of one, the implications of crisis resolution mechanisms for us at present are purely hypothetical but are relevant nevertheless.

An important lesson from the East Asian programmes is that the traditional recipes for crisis management which typically focussed on instruments for restriction of aggregate demand, may not be appropriate in situations where a loss of confidence has triggered large capital outflows which can generate strong contractionary influences in the economy through the effect on exchange rates and bank balance sheets.

Crisis resolution in such cases must focus on providing additional finance to fill the large financing gap created by the crisis (which are hopefully short term) and

to take all steps needed to generate a revival of confidence. A major problem in readying the Fund to play the role of crisis manager is the need to provide it with an adequate volume of financial resources.

The recent increase in Fund quotas has clearly helped but it is not adequate to manage a serious crisis. It is unlikely however that the major industrialised countries would be willing to support larger quota increases to give the Fund more access to its own resources.

One alternative would be to have pre-arranged lines of credit from the major Central Banks co-ordinated through the BIS which could be automatically drawn upon when needed for crisis management programmes approved by the Board. A more radical alternative is to amend the Articles of the Fund to allow the Fund to create special SDRs upto a predetermined cumulative limit in its favour which can be used by the Fund to finance crisis management programmes. Such SDRs would be credited back to the special SDR account when repaid and not be available for normal operations. Unlike normal SDRs the creation of these SDRs would not add to general liquidity, but it would give the Fund access to usable resources under its control for use in emergency situations to finance Board approved programmes.

The main conclusion to be drawn from the developments to date is that any assumption of easy money being made available with relatively low conditionality would be completely unwarranted. The emphasis on crisis prevention and surveillance in the ongoing architecture discussion ensures that at any given time there will be a list of weaknesses which the international community will expect countries to correct. While surveillance itself has no teeth and cannot be used to force corrective steps being taken, we can be sure that these items will figure on the agenda of conditionality for any country which needs assistance. We would be well advised therefore to work hard on preventing crises which means focussing on all the many issues that are relevant in that context which I have discussed in the first part of the lecture.

Discussion Paper

The need for a new global financial architecture has been extensively discussed in several official and unofficial fora for the past two years. The subject is both topical and important and I am grateful to ICRIER for giving me the opportunity to speak on this subject to such a distinguished group which includes Members of Parliament and some of the key officials participating in the ongoing international discussions.

Before discussing what the new international financial architecture is about, it is useful to clarify what it is not about. Developing countries have expressed concern about various aspects of the functioning of the international economic system since the collapse of the Bretton Woods architecture in the mid-seventies. Since then there has been much more instability in terms of interest rate variations as well as exchange rate fluctuations and this has often hurt developing countries. Instability may have been acceptable if it had been accompanied by higher growth on average but the fact is that growth rates in the post-Bretton Woods period have been lower than in the earlier period for both developed and developing countries. East Asia and India are exceptions to this since these countries experienced higher growth in the post-Bretton Woods period, but most developing countries experienced a deterioration in performance. Tight fiscal and monetary policies in industrialised countries have produced slower growth in world trade and a decline in the terms of trade for developing countries. Aid flows have shrunk and external debt burdens have increased. Performance improved somewhat in the 1990s, but the average growth rate of developing countries has remained low.

The new financial architecture does not address these issues. It focuses instead on the special problem posed by the increased frequency of financial crises in emerging markets in the 1990s which have affected countries as they have tried to integrate with international financial markets.

1. Experience with Recent Crises

The need for a new architecture arises because the financial crises experienced in emerging markets in the 1990s are very different from earlier episodes of balance of payments crises. They have been more frequent, more unpredictable and much more severe than crises in the past. They also reveal a new phenomenon of “contagion” whereby countries experience crises without any specific weakening in the so-called “fundamentals”. Instead, a crisis is triggered because collapse in one market leads to an indiscriminating loss of confidence in other emerging markets. We saw this in Mexico in 1994, which generated the tequila effect and we saw it again in East Asia in 1997 and later in Russia and Brazil in 1998. An important factor underlying this increased vulnerability to crises is the integration of financial markets of developing countries with

international financial markets which throws open the possibility of large movements of capital in response to a change in investor perceptions.

Though the fragility of the system was first revealed in the Mexican crisis of 1994, this did not lead to a generalised call for a new financial architecture partly because Mexico was not viewed as a particularly strong economic performer and partly because the crisis was quickly contained. The crisis in East Asia was different. First, these were the best performing developing economies and yet they suffered an exceptionally severe downturn belying widespread praise of their economic management until just before the crisis. Second, unlike the case in Mexico, the international community appeared unable to control the crisis quickly. The Fund moved quickly to establish programme for East Asia but the currency collapse in East Asia actually worsened after the Fund programmes were put in place. The Russian collapse in October 1998 was less surprising, because Russia was clearly a problem economy. It however, added a third dimension of concern because it led to problems in the Wall Street in the form of Long Term Capital Management fiasco. This showed that contagion was no longer just a developing country problem but could even spill over into industrialised markets.

Suddenly, the international financial system seemed much more unstable than was thought earlier and this led to many calls for basic reform of the system. Prime Minister Tony Blair of the U.K. exemplified the mood in his speech in the New York Stock Exchange in October 1998, when he talked about building a Bretton Woods for the new millennium and not holding back from thinking about the need for change. President Clinton also made similar, though not quite as radical sounding speeches calling for basic institutional change.

Things have changed substantially since then. Financial markets have stabilised. Korea has rebounded strongly and the other East Asian countries with the exception of Indonesia are also recovering quicker than earlier expected. The crisis in Brazil which was a fall out of Russia, also appears to have been contained. It has produced two years of stagnation in Brazil, but it has not led to a meltdown in the rest of the system as was once feared. With the return of stability, there is less talk about major institutional changes. The G-7 have announced that no major new international institutions are needed. The focus of the new architecture now is not on new institutions but on how to make the existing system work better.

While there can be no two opinions on the need to make markets function efficiently, the discussions on the new architecture reveal a basic divide between the perceptions of the developed world and the developing world. Developing countries typically take the view that market failures in financial markets can have serious consequences and often reflect factors entirely beyond the control of the affected country. Ensuring stability in financial markets in such situations requires a much better system of crisis management. Specifically, it requires that public

international financial institutions such as the IMF and World Bank should play a larger role by providing more money to crisis hit countries with less conditionality. These arguments focus on the need to create an international lender of last resort that can act in a manner similar to a central bank in a domestic financial system which stands ready to provide liquidity to otherwise sound banks faced with panic withdrawals. Developing countries recognise that such support cannot be divorced from conditionality of some sort but they often argue that the conditionality imposed by the multilateral institutions is not always “appropriate” for their circumstances.

Developed countries have a somewhat different perception of what is needed for stability. They too recognise that there is a role for public institutions, but that role should be carefully calibrated to the minimum needed to make markets function efficiently. Too large a role in their view may work in the opposite direction by generating “moral hazard” – i.e. encouraging the kind of imprudent behaviour which leads to crises, and its primary focus must be to prevent market failure. In other words, crisis prevention rather than crisis management must therefore be emphasised. Developed countries tend to be relatively optimistic about the effectiveness of such preventive policies in forestalling market failure and they are suspicious of any mechanism which provides easy money as part of post crisis resolution. In the rest of this lecture I will first focus on what people mean when they talk about crisis prevention and then look at crisis resolution.

2. Recipes for Crisis Prevention

One can identify five areas which are viewed as critical for crisis prevention and it is interesting to see what implications they have for the Indian situation.

a. The Macro Fundamentals

The first pillar of crisis prevention is to maintain sound macro-economic fundamentals. This is obviously important in itself because these so-called fundamentals are direct determinants of economic performance and therefore of stability. They are additionally important because they are the key objective signals which investors study and which therefore, determine investor confidence, itself a critical factor in avoiding crises. Strong fundamentals do not always suffice to avoid crises but they are the foundations on which any economy must build.

Experience with successive crises has produced an expanded list of fundamentals on which countries are expected to show good performance. We can run through this checklist and see how India performs on each count.

Fiscal and monetary discipline remains an extremely important indicator. Fiscal indiscipline was not the prime cause of the problem either in Mexico or in East Asia, but it was the principal weakness in both Russia and Brazil. This is clearly an area

where India's performance is weak. The scale of our fiscal problem is too well known to require further comment.

The size of the current account deficit is another important indicator. It was not thought to be important before the Mexican crisis because at that time, it was felt that as long as there was no fiscal deficit, the existence of a large current account deficit reflected only a large private sector deficit and as long as this deficit was being financed by private inflows, there was no problem. The implicit assumption was that the market always knows what it is doing and is self-stabilising. Attitudes changed after Mexico when it became clear that markets can sometimes ignore underlying problems and then overcorrect drastically. Today, a large current account deficit, especially if it has increased substantially in recent years, is regarded as a clear danger signal. This is particularly so if the deficit is accompanied by a significant appreciation in the real exchange rate.¹ Fortunately India looks quite good in this dimension. Our current account deficit is quite modest (around 1.5 per cent of GDP). The real exchange rate obviously depends on how we measure it, and there are differences on this but it is within 5 per cent of any reasonable base line norm.

Debt servicing capacity is another important macro-economic indicator except that today the focus is not merely on traditional debt service indicators such as the debt service ratio, but more particularly on the size of short term debt. The East Asian crisis is known to have been triggered by liquidity problems created by non-renewal of short term debt. The ratio of short term debt to foreign exchange reserves is a new indicator which has become the focus of attention. Fortunately again, India looks fairly good in this criterion. Many of the East Asian countries had very high ratio of short term debt to reserves reaching 170 per cent in the case of Thailand and over 200 per cent in the case of Korea. However our short term debt is nowhere in this danger zone. Even if we include debt by residual maturity of less than one year as short term debt, the ratio is still only around 45 per cent.

Slowing down in export growth is another warning signal especially if it occurs at a time when the current account deficit is expanding. This indicator has not been satisfactory in India after 1996-97 and up to 1998-99 because exports slowed down in this period. However our current account deficit is modest. We definitely need to do better on exports than we are doing, and this should receive priority attention, but on balance this is not a danger signal for crises at least in the near future.

¹ Both signals flashed red in Thailand when the current account deficit reached 7 per cent of GDP in 1996, very close to the Mexican level of 8 per cent in 1994, and the real exchange rate had also appreciated, though much less than in Mexico. It is important to note that the IMF did pick up this signal, and warned the Thai government about the problem at least a year before the crises. The warning was ignored and no corrective action was taken because Thailand considered itself a boom economy and investor confidence was felt to be high. It has been argued that if Thailand had taken corrective action earlier in 1996, the extent of the crisis in that country would have been moderated and in any case its ripple effects in other countries would have been much weaker.

Excessive growth of real bank credit is another possible danger signal. When money is flooding in, you can have a situation where large inflows lead to a sharp increase in liquidity which encourages banks to expand the real level of lending often leading to imprudent investments including investments in real estate against property as a collateral. This is not a problem in India because capital inflows are restricted and banks have also been traditionally discouraged from lending to property development. In fact industrialists frequently tell us that, if anything, the banks are lending too little.

This brief review suggests that India would stand up well against international scrutiny on possible danger signals for crises.

The main signal that can be said to be flashing red is the fiscal deficit. This is well recognised domestically and should receive urgent attention. I would like to emphasise that an important aspect of the future is that the fiscal position of the states will be a subject of increasing scrutiny. The crisis in Brazil was triggered by the announcement that the Brazilian state of Minas Gerais would not be able to meet its debt payments due to the federal government. India's fiscal health in future will increasingly be judged not just on the fiscal position of the Central Government but also on the fiscal positions of the states. It is well known that all our states are facing serious financial problems and unless this is corrected it is likely to reflect adversely on the country's credit rating.

b. Improved Information, Greater Transparency and Better Surveillance

The second pillar of crisis prevention in the new financial architecture is the need to improve the flow of information to financial markets. It is well recognised that financial systems suffer heavily from "information asymmetries" which reduce the efficiency of financial markets and often contribute to overshooting and instability. There is general agreement that developing countries are particularly vulnerable because information deficiencies are particularly high in their case. In other words, crises occur more frequently in developing countries because investors do not have adequate information about these countries and their assessments are therefore likely to swing from periods of excessive optimism or euphoria to periods of excessive gloom and panic. A steady flow of reliable information, available on a timely basis, is therefore expected to improve the quality of investor assessments and to avoid wild swings in investor confidence.

Recent experience certainly shows that inadequate information was a contributing factor in some cases. In Mexico, for example, when reserves were being run down in 1994 there was an interruption in the normal flow of published data on reserves so that the extent of the depletion of reserves to protect the peso was not known to the market. This exacerbated the collapse of confidence which took place later in the year. The Mexican experience focussed attention on the need to publish data on foreign exchange reserves on a regular basis.

However the experience of Thailand in 1997 showed that this may not be sufficient. Thailand had committed US \$30 billion from its reserves in forward sales to protect the baht. Although the reserves in the books of the Central Bank appeared substantial, they were actually pre-committed. Korea became vulnerable because its reserves were deployed not in safe liquid securities but were used to lend to overseas branches of Korean banks to enable them to meet their liabilities. When this information leaked out in October 1997, it contributed to a severe loss of confidence and run on the currency. Because of these experiences, there is now much greater focus on the need to provide full disclosure of reserves data as well as on all reserves-related liabilities (e.g. forward sales).

i) The SDDS

Responding to the need to improve availability of information the International Monetary Fund has developed its Special Data Dissemination Standard (SDDS) aimed at establishing a range of critical macro-variables on which data of high quality and meeting specified standards will be regularly published. Countries expecting to access world markets are encouraged to subscribe to the SDDS and forty-seven developing countries, including India, have already done so. The IMF has an electronic bulletin board in which details regarding the source of the data on each of its member countries and the timing and frequency of publication is made available, and in many cases there are hyper-links to country web sites which contain the actual data itself. This initiative is expected to increase the flow of timely information about economic performance and management in developing countries and make this information available internationally to all potential users.

The IMF has also developed an elaborate set of guidelines on good practices on fiscal side and monetary accounts which will push countries to higher standards of transparency and disclosure in these areas. The code on fiscal practices is particularly relevant for India since it recommends full disclosure of the macro-economic assumptions underlying the budget (e.g. the underlying rate of growth, rate of inflation, rate of growth of imports etc.) and also calls for projections of the next two years to be included with the projections for the budget year. It also calls for full disclosure of contingent liabilities incurred by the government including especially guarantees given by the government for the loans taken by public sector organisations. These are new areas of additional disclosure which could reveal areas of vulnerability in both the central and state governments. Disclosure is of course desirable since it will generate the internal discipline and external surveillance needed to avoid imprudent behaviour.

ii) IMF Surveillance

Making data available is only the first step. Crisis prevention also requires an improvement in assessment of the quality of economic management using such

data. While individual market participants will typically do this themselves on the basis of available data, it is generally argued that this process would be helped by institutionalised mechanism of external surveillance. The IMF's Article 4 consultation is an obvious vehicle for providing such assessments based as it is on access to published, and also to some unpublished data, as well as extensive discussion with the government.

The quality of IMF surveillance has been widely criticised for not providing early warning of problems in Mexico and later also in East Asia, except for Thailand. However there is general agreement that IMF surveillance must be strengthened as an instrument of crisis prevention. Traditionally, Article 4 consultation reports have been treated as confidential and many would argue that this confidentiality should continue. However, there is a growing perception in the international community that the outcome of IMF surveillance be made more transparently available to the market. The Fund has already introduced the practice of issuing Public Issuance Notices (PINs), which summarise the main features of the Board discussions on Article 4 reports, provided a country requests such release. India has been one of the countries allowing such releases. A pilot project is also underway to make the Fund Staff report public. Many countries have reservations on this but we can expect that market pressures will push the system towards greater disclosure. Countries trying to access capital markets are likely to opt for disclosure of the Article 4 report and once this is done, other countries will also want to follow suit since failure to do so can be interpreted as giving a negative signal to the market. Developments in this area have obvious implications for India since we may be faced with having to make a choice on whether to make such reports published. On balance, I would suggest that there is merit in allowing greater disclosure but for this we need to educate public opinion also to accept such reports even when they are critical.

iii) Rating Agencies

Apart from IMF surveillance, rating agencies are also involved in assessing the economic performance of countries. The record of rating agencies in the East Asian crisis does not generate much confidence as they misread the build up to the crisis and failed to convey any warning signals. In fact, after the crisis exploded, they may even have worsened the problem by resorting to a series of downgradings giving the impression of a progressively worsening situation. However they will no doubt learn from this experience and perform better in future. What this really means is that rating agencies are likely to make more frequent adjustments in performance ratings to reflect build up of pressure points even if the overall situation appears to be stable.

An important feature of rating agency reports is that they are less amenable to accept assurances given by governments and more likely to question the credibility of government policy intentions. The Fund is more likely to accept assurances of action in the first place expecting to hold judgement until

implementation is completed. Rating agencies on the other hand are free to speculate in this area and therefore more likely to be critical.

The increased role of rating agencies in creating an atmosphere of investor confidence has important implications for how we manage the interaction with these agencies. Traditionally, our official interaction has concentrated on the multinational institutions such as the IMF and the World Bank. More recently we have begun to interact with rating agencies also. One can safely say that these interactions will have to be made more extensive and systematic in the future.

iv) Regional Surveillance

Yet another idea in this context is the possibility of creating a regional oversight mechanism. The basic idea seems to be that countries in the same neighbourhood which are likely to be viewed in common by the world investors could consult among themselves to generate a common understanding and awareness of the external perceptions of the region as a whole. The presumption is that peer group surveillance will help to identify problems and encourage early corrective action. I have doubts about the usefulness of this initiative simply because regional official fora are unlikely to provide a free and critical assessment of each other's policies. In our particular case, because of our special situation in our region, including especially the very large disparity in the size between our economy and our partners and also relatively limited economic integration of the region thus far, the idea is even less plausible. However, it is likely to get a sympathetic response in certain parts of the world where regional cooperation and inter-regional economic integration is very strong.

v) Dialogue with the Private Sector

A new idea in this area is the possibility of a structured official-private dialogue between government on the one hand and private creditors and investors on the other. This is on the lines of what is apparently done in Mexico where officials of the Central Bank and the Finance Ministry meet regularly with representatives of foreign creditors and other financial investors. The meetings are used for a discussion on government policy as well as to address specific investor-creditor concerns. As India's interaction with foreign investors, foreign institutional investors and international financial community is more extensive it may be necessary to establish mechanisms of communication along these lines.

c. Strengthening the Financial System in Developing Countries

The third pillar of the new financial architecture is a broad based effort at strengthening the financial sector. Perhaps the most widely touted lesson from the crisis in East Asia, is that it was caused to a large extent by weaknesses in the financial sector. A weak financial sector in an environment of capital mobility can encourage an excessive flow of short term borrowings and lead to imprudent

financial intermediation. It is now generally recognised that while financial liberalisation which involves opening up the economy to the flow of external capital has important potential advantages, it also increases the risk of financial crisis if the financial sector is not strong.

The international response to this perception is to urge developing countries to give high priority to strengthening the financial sector. The major focus nationally must be on banks, which account for about 80 per cent of intermediation in developing countries, but the financial reform agenda is not limited to banks alone. It is also felt necessary to extend the process of financial sector reform to the securities markets which are growing in importance and also to the insurance sector since in many countries insurance companies are active players in the securities market. Reforms in the securities sectors also need to be underpinned by the reforms in what may be called the infrastructure for financial intermediation, including especially such areas as bankruptcy laws, accounting systems and corporate governance.

The general approach in strengthening the financial sector is to upgrade existing regulatory and prudential standards in the various components of the financial sector to bring them up to international levels. It is interesting to see what this implies for India in each of these sectors :

In the case of banking, the relevant international standards are the prudential norms regarding capital adequacy laid down by the Basle Committee. Fortunately we began the process of reforms in this area in 1991 with the First Narasimham Committee. The agenda for reform was widened by the Second Committee, which was established in 1997 in the aftermath of the East Asian crisis precisely because it was recognised that developing countries would be under increased pressure to strengthen their banking system. I do not propose to go into an elaborate examination of how far we have got in this area.² As a summary statement one can say that although our prudential norms and standards have been improved, they still fall short of international standards in several respects. However the Reserve Bank has indicated that standards will be tightened further so that these gaps will be bridged gradually.

The most important area which we need to address relates to the problem of weak public sector banks. We have to recognise that the current perception in international fora is that public sector ownership invariably means an implicit guarantee by the government against insolvency and is not conducive to sound banking. The international fashion is clearly for full privatisation of the banking system subject to strong financial regulation. This perception is not widely shared in India and there is as yet no political consensus to remove the government entirely from the banking sector. Official spokesmen have indicated

² See Ahluwalia, Montek Singh, "The IMF and the World Bank in the New Financial Architecture", paper prepared for the Intergovernmental Group of Twenty-Four on International Monetary Affairs, April 19, 1999.

a willingness to reduce the role of government participation below 51 per cent but that does not mean removing the government from banks. If we want to retain public sector banking while also conveying a credible impression of financial soundness, it is absolutely essential to tackle the problem of weak banks.

This problem has been recently examined by an Expert Committee (the Verma Committee) which has outlined a restructuring programme for three weak public sector banks with some tough cost reduction measures including staff reduction. The Committee has also indicated that there are another half a dozen public sector banks which may need similar attention in future. Unless suitable corrective steps are taken to deal with these banks, it will not be possible to convey a credible impression that banking sector reform is indeed underway. Indeed with the growth of information technology the need for restructuring to reduce costs will only increase. In this situation, toleration of the weak banks problem without effective steps at restructuring will only build up a hidden burden of recapitalisation which may have to be borne sooner or later by the budget. This is bound to reflect adversely on the international assessment of our fiscal position. It will also reduce the credibility of banking supervision in India and will negatively affect the image of the banking sector generally.

In the area of securities trading, the relevant international standards are those set by the International Organisation of Securities Commission (IOSCO). Our own regulatory body SEBI is a member of IOSCO, and has been actively engaged in upgrading our standards of disclosure, transparency etc in this area. Similarly, international standards for the insurance sector are laid down by the International Association of Insurance Supervisors (IAIS). India is one of the very few countries whose insurance sector is nationalised but the government has indicated its plan to open up this sector in the future. Fortunately, the Insurance Regulatory Authority has been in place for some time and has been working towards suitable prudential regulations to govern the insurance sector when private sector insurance companies come into operation.

Accounting standards are extremely important elements in the effort to reform the financial sector because banks and other investing institutions rely upon audited accounts to determine the financial position of companies to which they wish to lend or in which they wish to invest. International standards in this area are established by the International Accounting Standards Committee (IASC) which represents national bodies. The IASC has introduced international accounting standards governing a number of areas. However, accounting standards vary considerably across countries. The US GAAP for example is much stricter than international accounting standards and the Securities and Exchange Commission in the U.S. is not willing to shift away from GAAP on the grounds that this will lower the standards from the present level. Indian accounting norms show substantial deviations from international norms in several important areas. Our norms do not require consolidation of accounts of subsidiaries, segmented income reporting, disclosure of transactions with related enterprises, and

adequate disclosure of deferred tax liabilities. The treatment of finance leases and exposure to foreign exchange risk are other areas where there are gaps. It is important to close these gaps as early as possible so that we can have confidence in our accounting standards. This is perhaps less important for banks which have an intrusive ability to get information which they need but it is extremely important for the efficiency of the capital market where equity research depends heavily on published accounts. It is equally important to ensure that the existing standards are properly implemented. Deficiencies in this area arising from the lack of enforcement and inadequate penalties for failure are at least as important as weaknesses in the standards themselves.

The state of our bankruptcy laws is another area where we lag very far behind the international standards. It is generally recognised that efficient bankruptcy laws which enable lenders to foreclose in the event of loan defaults is an important precondition for an efficient financial system. Such laws are particularly important for the viability of the banking sector since banks cannot enforce their rights in their absence. This had surfaced as a major problem in East Asia as foreign creditors found that they were not in a position to enforce their claims. A major effort is definitely needed in this area if we want our financial sector to look good.

High standards of corporate governance are another essential requirement for generating facts in the efficiency and transparency of functioning of the corporate sector. This is an important ingredient once securities markets become important. As in other countries, this is not an area where standards are fixed by law. They have to be evolved through commonly accepted codes enforced in some cases by the securities regulators as the conditions for listing. Some progress has been made in this area in India in recent years but a great deal more needs to be done.

To summarise, we can definitely say that we have begun to move towards strengthening our financial system in the manner expected by the new financial architecture. However, what has been accomplished thus far can at best be described only as a good start. We need to persevere in these efforts in the years ahead especially in the banking sector but also on a broader front since the current perception of financial sector reform is somewhat all encompassing. Most important of all, we will need to benchmark our progress with that of other emerging market countries so as to ensure that we do not fall too far behind.

d. Strengthening the Financial System Internationally

The fourth pillar of crisis prevention consists of efforts to strengthen the financial system through international action. Several initiatives are under consideration in this context, some of which have potential implications for India.

It is now recognised that for each imprudent borrower there is a corresponding imprudent lender and this means it is somewhat unfair to attribute financial crises solely to weaknesses in the financial sector in developing countries. In order to address the problem, it is argued that prudential norms should be tightened at the lending end. One suggestion is that the present practice of allowing a lower risk weight (20 per cent) for short term loans to banks in developing countries and a higher risk weight (100 per cent) for longer term loans encourages the lending banks to lend only short term. Applying the same risk weight would remove this bias in favour of short term lending which we have seen creates systemic problems. This particular change will not have much impact on India since we do not allow short term lending. However it is also being proposed that the risk weight applied to banks should vary with the credit rating of borrowing banks and also with an assessment of the quality of the supervisory regime. This implies that India's future capacity to borrow through the banking system will be determined by the international assessment of the financial health of our banking system. In short, our banks must meet the standards expected by the evolving international consensus. This underscores the importance of accelerating banking sector reforms and also reform in other related aspects of the financial system.

There is also a strong consensus that the IMF, as part of its Article 4 surveillance and the World Bank as part of its country economic work, should cooperate to keep a close tab on the progress of financial sector reforms in the so called "systemically important" emerging market countries. In other words, these countries are likely to be subjected to enhanced surveillance of the financial sector. Whether we like it or not, we are bound to come under greater surveillance on this count and in the longer term our access to resources from these institutions is likely to be conditioned by their assessment of whether the pace of reforms in this area is appropriate.

Finally, there is a growing recognition that the international financial system needs some kind of body with broad international participation that can take an overview of the functioning of international financial markets viewed as a whole i.e. including banking, securities markets and insurance. In this context the G-7 have recently established the Financial Stability Forum (FSF), consisting originally of representatives of G-7 governments and central banks, the IMF and the World Bank, the Basle Committee, the BIS, IOSCO and IAIS. No developing country members were included initially. Membership of the FSF was subsequently expanded to include "major financial centres" and Hong Kong and Singapore have been admitted in this category. The FSF is an important new initiative in which representatives of industrialised country governments and the national regulators will interact with international institutions and also with the international bodies responsible for the evolution of international standards in each of the major financial markets.

The exclusion of the major developing countries from this grouping is obviously a serious deficiency. The G-7 have indicated that the membership of the group will be expanded to include developing countries in future, but so far expansion has been limited only to the so-called major financial centres. Expansion in future is likely to be governed by the extent to which the financial sector of the country has been sufficiently developed and integrated with international financial markets.

An interesting recent development is the recognition by the G-7 countries that the existing forums for intergovernmental discussion such as the Interim Committee and the Development Committee (with membership corresponding to the composition of the IMF and IBRD Boards) are not very suitable for substantive discussion. This was reflected in the decision of the US after the East Asian crisis to call a meeting of an ad hoc group of 22 countries (the G-22 which was later expanded to the G-33) to discuss the new financial architecture. The group included many systemically important developing countries which are not represented on the Boards of the IMF and IBRD because of its constituency system. More recently, the G-7 have created a new international group of 20 industrialised countries and developing countries as an informal Ministerial level group for regular discussion on international financial issues. India is a member of this group and it is likely that this group will become the principal forum for substantive discussion between industrialised and developing countries in a broad range of international financial issues.

An interesting asymmetry between the G-7 and the developing country members of the G-20 is that the former meets regularly in the G-7 forum and co-ordinate their positions on important matters. The developing country members of the G-20 are much less homogeneous and have fewer common perceptions than the G-7, but it would be desirable for them to evolve some process of consultations to achieve as much coordination as possible. India can be effective in these forums if our policy positions on critical issues are broadly aligned with the position of the other important developing countries in the new Group of 20. In general these countries are more financially open than we are and our policies will have to head in the same direction if we are to play a significant role.

e. The Role of Capital Controls

Another potentially relevant instrument for crisis prevention is the extent to which emerging market countries should liberalise capital movements. Before the East Asian crisis the general perception in the international financial community was that liberalisation of capital movements was an essential element of economic liberalisation, almost a touchstone of commitment to economic reforms. We in India had consciously adopted a cautious approach in this area and were often criticised for it. I can vouch for the fact that when government representatives met investors abroad, the question most frequently asked was when we intended to introduce capital account convertibility. Representatives of Indian industry also often took this position. With interest rates abroad being lower than

domestic interest rates, especially for shorter term loans, Indian industry often argued for freer access to external borrowing without the requirements of a minimum average maturity which were often insisted upon.

Attitudes have changed considerably following East Asia. It is now recognised that while liberalising the capital account has important advantages in terms of increasing access to international source of capital and allowing domestic residents to diversify their asset holdings, it also brings with it significant risks of instability because of the danger of a sudden loss of confidence – a danger to which developing countries are particularly vulnerable. This is especially so if the financial sector in developing countries is weak as this encourages imprudent intermediation of capital flows in a boom period should such a boom happen for whatever reasons. The new conventional wisdom therefore is that developing countries would be well advised to go slowly in liberalising the capital account. They should do so in a gradual and carefully sequenced manner *pari passu* with efforts to strengthen the financial sector.

What does this mean for policy in India? First let me emphasise that one conclusion, which is too often heard in the public debate in India and which is definitely misleading, is the notion that East Asia somehow vindicates those who have argued against opening up the economy to trade and foreign investment! The fact is that no one anywhere in the world, and certainly not in East Asia, thinks that the East Asian crisis was caused by the openness of these countries to trade and foreign direct investment. Even Malaysia, which is sometimes cited as having shifted its position towards greater controls, has not made any moves to increase trade protection or to tighten the rules for foreign direct investment. They have only tightened the rules for certain types of short term flows. The merits of open trade and foreign investment policies are too well known to warrant repetition. I can understand that those unconvinced on this point may want to argue the position and this certainly is a legitimate issue to discuss. But one should not expect to find any support for these views from the experience of East Asia.

The real lesson of East Asia is that countries should be careful about liberalising short term flows. In this context there is a great deal of appreciation, if not actual support, in the international community for the type of market friendly controls on short term flows that have been used in Chile and Columbia. In essence these consist of the requirement of placing a certain proportion of capital inflows in the form of an unremunerated deposit with the central bank for a period of one year. The requirement can be applied to all debt, or even all inflows since it is difficult to distinguish debt flows for portfolio investment, and it serves as an implicit tax on capital flows which is higher for short term flows. This is because the implicit tax (the interest foregone on the unremunerated deposit for one year) is relatively small over the life of the investment for long term flows.

One can draw some lessons for policy from these developments though, as I mentioned earlier, there is less consensus in this area than in most others. I would summarise the lessons as follows :

East Asia vindicates continuing caution on capital account liberalisation as long as our financial system is declared to be inherently weak. This would not be viewed internationally as a permanent justification for restricting capital mobility, but rather as recognising a second best outcome. Internationally it would be argued that the case for restricting capital flows implies the need to move rapidly to increase the strength of the domestic financial system.

There is justification for imposing controls on short term flows but not on long term flows. The restrictions on foreign direct investment in our policy for example cannot be defended on the grounds of protecting our economy against instability. They have to be defended on other grounds such as the desire to impose limits on the share of foreign investment in individual sectors. However, this does not provide a justification for restrictions on the ability of firms to borrow longer term funds abroad.

It could be argued that domestic firms with earnings dominantly in rupees should not expose their balance sheets to unhedged foreign exchange exposure beyond a point. But the appropriate way of addressing this problem may well be to strengthen the domestic banking system to discourage lending to such firms and increasing the disclosure required in accounting practices to reveal such exposure, rather than in government controls arbitrarily limiting financing choices of the companies. Some liberalisation of access to long term borrowing can therefore be justified.

A related issue in the context of capital account liberalisation is the role that the Fund should play in policing restrictions on the capital account imposed by member countries. At present, the Fund's Articles of Agreement do not give the Fund any mandate in the area of restrictions on capital account transactions. In 1997, the Fund's Interim Committee had directed that the Fund should explore the possibility of amending the Article to include liberalisation of capital movements as one of the "objectives" of the Fund. Developing countries had reservations on this approach and the financial instability created by the East Asian crisis has clearly put it on the backburner. Developing countries are understandably wary of accepting any restrictions on their sovereignty in this area and in particular are concerned that an expansion of the mandate of the Fund might be translated into tougher conditionality on liberalising capital movements when seeking assistance from the institution.

This is clearly a difficult issue and discussions are continuing in the IMF Board and it is not clear at present how these will evolve. However, it can be argued that given the importance of international capital flows in the world economy, and the fact that all developing countries including India are progressively opening up

to international financial markets, it is something of an anomaly that the Fund has no mandate at all in this area. One can argue that there is a case for giving the Fund some sort of a mandate which would enable it to play a larger role in surveillance of restriction on capital transactions especially at times of stress. The mandate should not allow the Fund to force developing countries to adopt any particular regime. Countries which want to retain the flexibility to impose capital controls, and even to intensify them in emergencies, should be allowed to do so. But the Fund could be given an explicit mandate to regularly review these policies (which it does even today). Further, one can also argue that countries should have the option to voluntarily accept certain disciplines in this area when they feel they are ready to do so. Obligations voluntarily accepted would give the Fund a special status in policing these obligations. Countries introducing restrictions in this area at times of emergency after voluntarily accepting obligations should be willing to commit themselves to some form of consultation with the Fund with a presumption of a Fund supervised return to normalcy as soon as possible. This would encourage the evolution over time of an internationally agreed discipline on what kinds of restrictions on capital movements can be imposed in different circumstances.

Such a voluntary acceptance of discipline and the existence of international policing would improve investor confidence in countries accepting such disciplines. Developing countries may have reservations on agreeing to such arrangements but they could be persuaded to accept them as part of a package in which the IMF's capacity to help countries in times of difficulty is also strengthened. I will return to this subject later when we deal with crisis prevention.

Exchange Rate Regimes

Another area of policy which is regarded as important for crisis prevention is the regime regarding exchange rates. Many observers of the East Asian crisis have commented that the pursuit of so called "fixed exchange rate" policies in which exchange rates appear to be fixed with respect to one of the major currencies, but in times of crisis the peg is abandoned, are a major cause of problems. The appearance of stability leads to a neglect of exchange risk which plays a role in encouraging large inflows and when these flows are reversed at a time of crisis the collapse of the exchange rate is viewed by investors as a major policy failing.

The dominant view in response to this experience is that developing countries would be well advised to adopt more flexible exchange rate policies. However, this is not a consensus view. There are a number of advocates of genuinely fixed exchange rates, the fixity to be achieved by institutional arrangements such as currency boards as in Argentina or Hong Kong. In extreme cases, it is argued that even a currency board arrangement may lack credibility if it is feared that it may be abandoned and to protect against this possibility some observers have even recommended outright dollarisation.

The choice of exchange rate policy is a difficult issue and the final decision depends upon the policy towards capital controls and the degree of independence desired for monetary policy. It is generally recognised that no country can simultaneously achieve all three objectives of stable exchange rates, free capital movements and an independent monetary policy. It is necessary to give up at least one of these. Exchange rate stability can be combined with an independent monetary policy if capital controls are in place. This is essentially the situation we face in India. However, if capital movements are completely liberalised, as has happened in many developing countries, then the country must either abandon monetary independence or abandon exchange rate stability. International opinion has not crystallised unambiguously on how these choices should be made. It is accepted that in certain situations (e.g. a small country trading dominantly with one currency area) the authorities may be willing to abandon monetary independence in favour of exchange rate stability. However, it is unlikely that many countries will be willing to give up monetary independence and this points inevitably to greater exchange rate flexibility.

The lesson for India on exchange rate regimes needs to be carefully drawn. At present we make extensive use of capital controls and can therefore afford to combine monetary independence with a measure of exchange rate stability. However, as we loosen up on capital controls in future, we must be ready to accept greater exchange rate flexibility. It is necessary to begin moulding public opinion towards this end. We have done quite well in recent years in ensuring a measure of exchange rate flexibility but it is still true that changes in the exchange rate are viewed as highly sensitive. The press is liable to give banner headlines even when the exchange rate weakens by a few paise. This reflects a hankering for fixed exchange rates which is simply not feasible.

3. Mechanisms for Crisis Resolution

Let me now turn briefly to the need for institutional changes aimed at facilitating post crisis resolution. As I have already mentioned, there is much less agreement in this area than in crisis prevention. Developing countries feel that the process of integration with the international financial system, which involves opening up the capital account, exposes them to the risk of severe crises arising not because of economic mismanagement on their part but because of irrational behaviour caused by the inherent volatility of “uninformed” investor sentiment which is prone to fluctuate between euphoria and panic. Such panics when they occur need to be quelled by the availability of a credible international lender of last resort that can quickly provide a large volume of resources to deserving countries. The analogy is usually drawn with the role played by central banks when they act as lenders of last resort for sound commercial banks threatened by a run on deposits. It is therefore argued that the International Monetary Fund must be suitably strengthened to enable it to act as a lender of last resort for developing countries.

Developed countries on the other hand, recognise that there is a need for an international crisis manager but they are extremely wary of a tendency to attribute crises purely to panics with no underlying economic weaknesses which need correction. They feel that any perception that public international institution will be available to bail out countries in a crisis will only encourage imprudence on the part of borrowers as well as lenders. Then any use of public resources must be sparing, associated with high conditionality to reduce moral hazard and should as far as possible strengthen market forces. This means in practice that lenders must bear some of the losses (the current buzzword is “take a hair cut”) rather than expect to be bailed out.

The Fund has introduced several innovations that enable it to play the role of crisis manager more effectively than in the past. First, it put in place an Emergency Financing Mechanism in 1996 after the Mexican crisis which enables the Fund to respond very quickly to a crisis situation. Speed of response is indeed important and although Fund programmes have been criticised for pushing the wrong type of adjustment policies and also for not being able to provide enough finance, they cannot be criticised for lack of speed.

Second, at the time of the Korean crisis, the Fund created the Supplemental Reserve Facility which enabled the Fund to provide finance beyond the normal quota based access limits to handle crisis situations where a loss of confidence creates a very large financing gap. As is appropriate in such situations, the period for which the financing is made available is very short (1½ years extendable by another year) and it is at a much higher interest rate than normal Fund financing, but it meets the requirement of providing finance in large amounts.

Third, the Fund has recently introduced the Contingent Credit Line Facility which enables developing countries anticipating a crisis of confidence unconnected with fundamentals to tie up Fund assistance in advance based on an assessment of the adequacy of current policies. This facility enables well managed countries (the good management to be in effect pre-certified by the Fund) to obtain assurance of quick support in the event of a crisis caused by loss of confidence provided its performance continues to be in line with an agreed programme and also provided that in the event of a crisis the country is willing to take.

Since we are not in a crisis, nor are we in any immediate danger of a crisis, the implications of crisis resolution mechanisms for us at present are purely hypothetical. However there are implications which are relevant for all developing countries and are therefore also relevant for India.

The first of these relates to the nature of Fund conditionality. Clearly, the effectiveness of a crisis resolution mechanism in handling a crisis and bringing about a quick return to normalcy depends upon the nature of the conditionality

associated with the Fund programme. An important lesson from the East Asian programmes is that the traditional recipes for crisis management which typically focussed on instruments for restriction of aggregate demand, may not be appropriate in situations where a loss of confidence has triggered large capital outflows which can generate strong contractionary influences in the economy through the effect on exchange rates and bank balance sheets.

Crisis resolution in such must focus on providing additional finance to fill the large financing gap created by the crisis (which are hopefully short term) and to take all steps needed to generate a revival of confidence. Unfortunately the art of reviving confidence is little understood at best and it is extremely difficult to be sure of what measures are most likely to succeed in any specific situation. The time lag between the initiation of policy correctives and their impact on confidence in the market is also uncertain. In practice this means that unless very large financial resources are available there may be a period (hopefully short) during which there is little that the authorities can do other than weather the storm.

A major problem in readying the Fund to play the role of crisis manager is the need to provide it with an adequate volume of financial resources. The introduction of the Supplemental Reserve Facility allows the Fund to lend to countries beyond the normal access limits which are related to the size of quota. However, there is no assurance that the Fund would be able to mobilise the resources needed to meet the requirements of a number of countries if it should be called upon to do so. This inadequacy of resources has in the past forced the Fund to deal with crises by trying to arrange finance from different sources including multilateral agencies such as the World Bank and the regional development bank and also bilateral assistance. However the experience with this approach has been mixed. It worked very well in Mexico where the U.S. made a substantial contribution but in East Asia, the conditions under which the bilateral component of the financing package would be available were highly uncertain. It has been argued that this uncertainty was known to the markets and this reduced the credibility of the East Asian financing packages and may have contributed to their failure to stem the panic at an early stage.

It is not clear how this problem can be handled in future. The recent increase in Fund quotas has clearly helped but given the scale of resources needed to manage the new kind of crises it is far from clear that the Fund will be able to manage a succession of future crises without having to approach other lenders. This creates uncertainty about the volume of resources available and makes the outcome dependent not just on multilateral processes but also on the perceived importance of individual countries. A financially stronger IMF would avoid this problem.

It is unlikely, however, that the major industrialised countries would be willing to support larger quota increases to give the Fund large access to its own

resources. One alternative would be to have pre-arranged lines of credit from the major Central Banks co-ordinated through the BIS which could be automatically drawn upon when needed for crisis management programmes approved by the Board. A more radical alternative is to amend the Articles of the Fund to allow the Fund to create special SDRs up to a predetermined cumulative limit in its favour which can be used by the Fund to finance crisis management programmes. Such SDRs would be credited back to the special SDR account when repaid and not be available for normal operations. Unlike normal SDRs the creation of these SDRs would not add to general liquidity but it would give the Fund access to usable resources under its control for use in emergency situations to finance Board approved programmes.

There is little immediate prospect of action in this area. However, as we gain experience, and especially if there is a repeat of multiple crises, some way will have to be found to deal with the resource requirements of the Fund. The present arrangements are certainly inadequate.

As I have already mentioned, it is difficult to draw implications for India or for any other country of the present state of the consensus on crisis resolution because much depends upon how the various facilities recently introduced will operate in the event of a crisis and whether there will be an overall resources constraint. The main conclusion that I would draw is that any assumption of easy money being made available with relatively low conditionality would be completely unwarranted. The emphasis on crisis prevention and surveillance in the ongoing architecture discussion ensures that at any given time there will be a list of weaknesses which the international community will expect countries to correct. While surveillance itself has no teeth and cannot be used to force corrective steps being taken, we can be sure that these items will figure on the agenda of conditionality for any country which needs assistance. We would be well advised therefore to work hard on preventing crises which means focussing on all the many issues that are relevant in that context which I have discussed in the first part of the lecture.

Discussant's Comments

Shankar Acharya

It is very difficult to comment critically on Montek's extremely lucid, well-argued and cogent presentation –especially since I agree with almost everything he said. However, let me make a few comments.

Early in your remarks, Montek, you indicated that developing countries have been unhappy with the functioning of the international financial system since the collapse of Bretton Woods arrangements around the mid-1970s and there has been greater instability in international macro parameters since then.

I do not think Montek touched upon the counterfactual evolution of global parameters that would have occurred if the Bretton Woods system had not collapsed. After all, it collapsed not because somebody made it collapse. Rather, events and economic forces did. If there had been a successful attempt to preserve the Bretton Woods system in the early 70s, I think it could well have been much more costly to the world economy and to developing countries. One could also argue the case that large chunks of developing countries have done very well during post-1975 period despite all the vicissitudes in the international economy including, of course, oil shocks.

The second point on which I very much agree with Montek, is the complete change in the G-7 perceptions of the international financial system between the September 1998 Annual Meetings of the World Bank and IMF and the Interim/Development Committee Meetings in April 1999. Within those six short months, I think the tenor of views that Montek outlined has emerged. And I do agree with his basic assessment that G-7 countries now think of those financial squalls of 1997-98 (the crisis in East Asia, Russia and Brazil) as events of the past which have been contained with relatively little cost to the heartland economies of G-7. Yes, the cost has been very high in Indonesia, Korea, Thailand and so on, although the G-7 have maintained that the cost had been contained, partly thanks to the IMF sponsored stabilisation programmes, partly thanks to the miracle of the booming US economy which has continued to be the importer of last resort from the flagging world economy, and a number of other factors. Basically, I agree that the G-7 do not feel that the whole international financial system has to be radically re-engineered. This is clear from the recent G-7 communiqué from Cologne. There is also a good speech by US Treasury Secretary Robert Rubin, dated April 21, 1999. It is available on Internet and it really lays out their perceptions and agenda.

One point I would make is that a lot of discussion on the international financial architecture is going on in very separate tracks from the set of discussions that Nripi Khanna and his colleagues in Commerce Ministry focus on from the trade

side and from the WTO side. I do not feel there is much interaction between these separate tracks. I would approach it from another angle. I think it is very important for us in India to see how we might manage to get a growing proportion of world exports. We have not done very well over the last few decades as we all know. India's export share declined from 2.5% of world trade in 1950, to 0.4% in the mid-80s, and more recently it increased to about 0.6%, but stagnated in the last couple of years. To my mind, our export performance is going to be a very important feature of our external effectiveness in all international dimensions, including those on the international financial architecture. And to that extent our constructive and effective engagement in the WTO is very important for our overall international effectiveness.

I think this whole transparency issue that has come up as a result of the Asian crisis has had some beneficial effects for us. Thanks partly to autonomous developments and partly to Asian-crisis-related international expectations on various codes and transparency checklists, there has been some improvement in the public availability of our macro data. This is very important for the people of India. On areas like fiscal accounts, every month now anybody who is interested in the summary accounts for the Central Government finances can find them on the Internet. On quarterly national accounts, we are preparing them now for the first time. As you know, two weeks ago they were published. Quarterly balance of payments did not exist earlier. Now they are available. All of this is somewhat linked with the SDDS initiative and that is, in turn, part of the whole transparency bandwagon. These improvements in information are significant benefits to the people of India, including professional analysts and journalists.

On the rating agencies set of issues, I just wanted to share with you one thought. Recently, at a conference in Kathmandu on the international debt issues, representatives from Standard and Poor's turned what I thought was one of the strong points of Indian performance into a virtual weakness! They converted the strong point that there is high consensus on economic reforms cutting across party lines into "strong consensus on weak reform"! So this is the sort of thing that you cannot stop from rating agencies. Whether they are right or wrong is a different issue. That they will make up their own minds is the reality.

On domestic financial systems, I think this is going to be crucial. I agree with Montek that this is going to be crucial to our credibility and strength in the international arena. And here I must say I do not see a great deal of progress in three major areas, which were touched upon by Montek. First is the issue of public ownership of our banks. We have now become a complete outlier if we look around the world. With the exception perhaps of China there is no other country, which has such a high proportion, i.e. 80% or so, of its bank deposits in public sector banks. And there are good efficiency reasons why things have changed in the rest of the world. Second, as Montek pointed out, we are not doing much with what may be called the weak banks problem. This is a serious problem. And, third, which is perhaps a little bit exaggerated by some of our

international interlocutors, is the problem of directed credit. We call it priority sector lending.

On capital account convertibility, I agree with Montek's basic view that a standstill is not very tenable. However, requiring some strengthening of domestic financial and fiscal systems prior to further liberalisation of the capital account is a tenable position. By the way, perhaps Montek left a sense that we already have a substantial amount of capital account convertibility and our progress is quite good. But there is a very important dimension where we are very weak even when compared to those countries which do not have full capital account convertibility and that is the convertibility enjoyed by residents. As I recall, the Chairman of the Report on Capital Account Convertibility has subsequently described our existing controls on residents as "barbaric". And I think he has a point. There is clearly room for significant liberalisation in this dimension without risk of generating serious pressure on macro financial balances.

On the exchange rate regime, I disagree with Montek since our success perhaps lay in the past, and the real difficulties are going to be in the future. If you assess our performance in the last decade from 1990 onwards, we have been moderately successful in managing a reasonably flexible, market-responsive exchange rate policy, without landing us into any kind of serious "overshooting" or long term jams. Yes, it has involved some jagged corrections, which were largely inevitable, when they occurred. But I am not so sure that the political acceptability for a flexible exchange regime will be all that great in the next six months to a year, or that its prognosis is quite so good as it has been in the last two years. This is a point on which I hope I am wrong.

The last point, going back to the issue of export performance, is the current account deficit in our balance of payments and so forth. I want to close on this note. What we do about our international competitiveness is really at the heart of our future strength not only in managing our own economy but also in terms of our ability to engage credibly in international fora. Most of the issues we talk about under the rubric of "international financial architecture" relate to various kinds of access to international borrowing. Our basic external and internal economic strength, on the other hand, will come from our success in strengthening our international competitiveness to achieve high and sustained growth in our earnings through exports of goods and services. Without this success, we cannot expect to be saved by whatever changes are eventually engineered in the international financial architecture.

Summary of Discussion

How 'new' is the 'new financial architecture'? This question was posed at the very outset of the discussion that followed the comments of the principal discussant. It was suggested that neither in terms of the role of the IMF nor in terms of the influence of credit rating agencies, nor even in terms of the "rules of the game" on capital account convertibility or exchange rate regimes, was there anything new in the so-called "new financial architecture". Responding to this sweeping statement, Dr. Ahluwalia said that what was new about the emerging "rules of the game" was that there was much greater emphasis on making financial markets work more efficiently and avoiding moral hazard. The role of the Fund as a direct provider of finance was not viewed as the most critical instrument in crisis management. Instead there was greater focus on crisis prevention. If anything, it is the surveillance role of the Fund that is being strengthened. On the whole, the 'new rules of the game' were also likely to be more intrusive in the sense of emphasising closer scrutiny of internal economic policies and especially the health of the financial sector than before, and these issues would play a large role in any future conditionality.

There was considerable discussion on the central importance of financial sector reforms and fiscal stabilisation in India as a means of ensuring that the Indian economy acquired the resilience to withstand external market-induced pressures and face up to multilateral discipline. There was agreement that internal reform within the Indian banking and financial sector is vital. Dealing with issues relating to ownership, management and non-performing assets (NPAs) of financial institutions and banks is urgently required if the domestic "financial architecture" has to be reformed and modernised to meet both internal and external challenges, including those posed by changes in the international financial architecture.

Several interventions focused on the issue of internal reform. In his response Dr. Ahluwalia emphasised that reform of the domestic financial sector, not just banking but also insurance, non-banking financial intermediaries and the financial sector as a whole would be the centre of attention. He said India would be well advised to accelerate the process of upgrading our regulatory standards to reform the banking system. Fragile banking systems are viewed as a future threat to fiscal stability, since it is the taxpayer's money which is used to bail out banks. Increasingly they will be a signal to the rest of the world that all is not well.

A second issue that came up was the fiscal health of state governments and its implication for fiscal stability and macroeconomic policy at the national level. Attention was drawn to Dr. Ahluwalia's description of the role played by weak financial management of provincial governments in Brazil in drawing the Brazilian economy into a major external payments crisis. In India, too, state level finances

were identified as vital to the health of the financial sector and to fiscal management.

On the role of 'market forces' in the new financial architecture, questions were raised as to whether they contribute to greater stability of management. Are credit rating agencies better informed, do they not make mistakes, can their assessments be regarded foolproof and reliable? In response to the point made by Dr. Ahluwalia that credit rating agencies are likely to play a greater role than even the IMF in the new financial architecture in assessing the performance of governments, it was commented that these agencies have not demonstrated any superior track record in sovereign rating and country risk assessment. Dr. Ahluwalia agreed but he felt that the agencies are likely to learn from the experience and be more keen to send out warning signals in future.

It was suggested that India's financial sector ought to be more diversified so that institutions can spread their risk across a range of activity. It was not good for large financial institutions to be narrowly focussed in terms of their exposure. There was general agreement that apart from portfolio diversification, financial sector reform in India must also focus on legal reform, legislation of new bankruptcy laws and labour market reform. Without legal and labour market reform, financial sector reform is not possible.

On the issue of exchange rate management, some participants expressed the view that India did not really have a flexible exchange rate system and that the external sector reform programme of the 1990s amounted to nothing more than a movement from a poorly managed fixed exchange rate system to a slightly better administered "managed" exchange rate system. In the absence of a free market system, there can be no really flexible exchange rate system. Dr. Ahluwalia pointed out that there was no such thing as a fully market determined exchange rate system in which the monetary authority never intervened. It was true that in India we tended to react to exchange rate movements rather quickly but this was in the short term. Over time the rate has been allowed to adjust. In any case the key issue was that as we liberalise controls further and accept greater flexibility.

Another issue that was commented upon was the role of multilateral surveillance as against not just market forces, but unilateral discipline and whether the United Nations ought not to play a larger role in this. Dr. Ahluwalia was sceptical about what role the U.N. can play, considering that over time it is the Bretton Woods institutions which have acquired greater influence than U.N. bodies in international economic management. He agreed, however, that while most countries were interested in a truly multilateral "rule-based" system for surveillance and management of crises, what we had was a system which was overly influenced by the G-7 and sometimes just the G-1. This is a reality we have to come to terms with. However, he went on to add that governments must recognise that Central Banks are being called upon to play a more important role in financial sector surveillance and management and that this has implications for

the role of the central bank in India too. Independence of a central bank from the finance ministry may in due course become a test of financial health.

A question was posed if regional financial institutions, like an Asian Monetary Fund, may not be better suited to deal with crises. Dr. Ahluwalia said he was against the idea of creating such regional parallels to the IMF and that it was more important to augment the funds of the IMF rather than create new regional financial institutions. This was particularly important for India since we are not part of any regional grouping. However, regional associations can create systems for surveillance. ASEAN is taking an initiative to ensure surveillance of its member countries. The IMF can benefit if such regional associations can enforce discipline in the market place though Dr. Ahluwalia doubted that this would be effective.

On the issue of capital account convertibility, it was pointed out in the discussion that apart from the 'milestones' indicated by the Tarapore Committee, an important requirement for sustainability and stability of a fully convertible system is the health of the domestic financial system. Pending the establishment of a strong financial system and macro balance there is some merit in continuing to retain some capital controls. The 'Asian economic crisis' drew our attention to the importance of financial sector reform preceding capital account convertibility. However, it was argued by some that unless full convertibility is introduced there may not be adequate market pressure to reform the financial sector. Full convertibility can therefore act as an instrument of reform.

In his final response Dr. Ahluwalia suggested that we must be under no illusion that if we reform our financial sector we would secure immunity from any crisis. Such reform was important in itself, and was necessary to reduce the probability of crisis, but it is no guarantee against future problems. He also emphasised the distinction between "volatility" and "crisis". Fluctuations in exchange rates or in reserve levels do not amount to a systemic crisis. A modern economy is always exposed to the risk of volatility and efficient markets are capable of handling such pressures.