V REVIEW OF MECHANISMS

Monitoring and surveillance activities are carried out at different levels (national, regional and global) and focus on different aspects (macro-economic, financial and institutional), varying with the mandate of the specific body involved. Depending on their structure and objectives, monitoring mechanisms employ different methodologies and approaches. There are two general approaches to monitoring and crisis prevention.

The first refers to the traditional practice of surveillance, which is a process by which certain bodies oversee the economic policies of its members to promote global well-being (meaning financial and economic stability). IMF, for example, undertakes bilateral consultations and policy advice under Article IV of its Articles of Agreement. In the G-7 system, surveillance implies policy coordination so that exchange rate and macroeconomic stability are maintained. Under this approach, the forum or specific body takes the initiative in identifying certain worrisome trends that demand correction if global or regional economic stability is to be achieved.

A more recent paradigm, in contrast to the watchdog approach, is to promote transparency and standards in policy formulation at the national level and in business practices at the enterprise or financial firm level. It is now widely recognized that, in the light of the increasing sophisticated and rapidly changing markets, policy makers and regulators must rely increasingly on market-led processes to provide the discipline required to lead to prudent and stabilizing behaviour.[1]

Promotion of transparency at all levels – decision-making in the multilateral institutions, domestic policy-making and disclosure by financial entities and business corporations – is deemed a crisis-prevention step insofar as a financial crisis happens as a result of a paucity of information and asymmetries in access to it. Transparency is considered the best solution to contagion because at the core of contagion is the lack of accurate and timely information which would allow economic agents to distinguish which economies or institutions are sound and which are not. Panic often occurs because of uncertainty; better information aids good judgement and minimizes the risk of bad judgement. If the problem is a lack of publicly available information, then the answer lies in better data quality and improved dissemination methods. The rationale is that better-informed investors, creditors or economic agents would be in a more sound position to take prudent decisions with respect to lending, borrowing and investment. It is also expected that the collective action of the (better-informed) markets could impose discipline on countries which are pursuing unsustainable policy mixes. In this sense, the approach of enhancing transparency is more market-oriented and that of traditional surveillance more interventionist.

There are also practical reasons for including standards for transparency in monitoring exercises. The pace of innovation in products, transactions and financial instruments makes it difficult for monitoring agencies to keep track of developments. Furthermore, market participants are engaging in rapidly changing and more complex transactions which regulators cannot be expected to anticipate with appropriate legislation; the regulatory catch-up is a daunting challenge. In addition, the number of players that invest in emerging markets is large and growing, and this is increasing pressure on monitoring agencies. In the light of these changes, rather than respond with stricter regulation of the traditional sort, regulators are increasingly choosing to rely on the judgement of market participants,

[1] See the arguments in support of this in William R. White, "Promoting international financial stability: the role of the BIS", paper presented at the Conference on Coping with Financial Crises in Developing and Transition Countries: Regulatory and Supervisory Challenges in a New Era of Global Finance, organized by the Forum on Debt and Development, Nederlandsche Bank, Amsterdam, 16-17 March 1998.

who are likely to have a better understanding of market developments. Such judgements require standardized information distributed on a frequent basis.

In reaction to these arguments, IMF is taking steps to enhance transparency by promoting the Special Data Dissemination Standard (SDDS) which is intended for countries that have or seek access to international capital markets, and the General Data Dissemination System (GDDS) for the other countries. BIS is also improving the coverage, quality, timeliness and availability of its data series. Further, in 1999, the Group of Ten (G-10)[2] countries committed themselves to a template for revealing their foreign exchange positions with a view to encouraging emerging markets to do the same.

The two approaches of surveillance and transparency are not exclusive, but rather complementary. Thus, initiatives aimed at improving the provision of information and facilitating its effective dissemination should be considered a concrete modality of crisis prevention.

The setting up of standards and codes for prudential purposes represents another aspect of the new paradigm, as the provision of agreed standards helps policy makers and markets to interpret the data. Standards provide benchmarks (and targets) that can assist authorities in monitoring their financial systems and initiating corrective responses when the actual situation deviates from the prudential standards. Furthermore, international standards help markets make informed judgements about the credit risks of countries as well as allowing them to discriminate sufficiently among countries to prevent contagion. Codes provide best-practice benchmarks for policy formulation. To the extent that standards and codes promote better policy formulation, which, in turn, makes the economic and financial systems of countries more robust, they should be considered as part of any crisis-prevention package. The working groups of the Financial Stability Forum[3] have recommended the establishment of standards of best practice in a number of areas affecting financial stability. They are exploring improvements in disclosure by large financial institutions of all kinds that would be most effective for improving systemic stability. They are also considering the feasibility of providing additional aggregate information on activities in currency markets that could improve market stability by enhancing the capability of market participants to identify the potential for large exchange rate movements and for contagion, especially in emerging markets.

The provision of standards and codes through international cooperative efforts can also be justified on the basis of scarce resources and efficiency. Because certain institutions have expertise in specific areas, they are in the best position to formulate the standards. Furthermore, these and other bodies can facilitate the adoption of codes of best practices or standards by providing training and other forms of technical assistance for capacity-building. The concerted adoption of codes and standards could help build confidence. Peer pressure can also be used to push the adoption of transparency and best practices. One strategy is to convince a small number of financially robust countries to adopt the standards, and other countries will then be under pressure to follow. In fact, IMF has moved in this direction with the release of the initial transparency reports, a development discussed later in this chapter.

In the following sections, the processes and technical aspects of the crisis-prevention mechanisms in place in international institutions are discussed in more detail. Annex V.1 provides a succinct summary of measures taken in the last two years by international institutions to strengthen the international financial architecture in terms of surveillance monitoring and transparency. Annex V.2 provides a brief summary, in alphabetical order, of the status of international codes and standards affecting financial markets.

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[2] The Group is made up of 11 industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), which consult and cooperate on economic, monetary and financial matters.

[3] The Financial Stability Forum is the current modality for coordination on promoting international financial stability set up by the Group of Seven Finance Ministers and Central Bank Governors. The web site is available at <http://www.fsforum.org/Home.html> (26 January 2000).

INTERNATIONAL MONETARY FUND

Given the rapid transmission of financial disturbances in the world capital markets, IMF[4] is increasingly called upon to play a central role in the prevention, containment and resolution of crises. This section reviews the different modes of surveillance and crisis prevention functions that the IMF performs, either traditionally or in the context of the new financial architecture.

Under its Articles of Agreement, the principal function of the Fund is to supervise the international monetary system. This involves (a) surveillance over the monetary and exchange rate policies of the members; (b) issuing policy recommendations; and (c) granting credit to members with temporary balance-of-payments difficulties subject to certain policy conditions.[5] In addition, the Fund has a mechanism to enhance the international supply of liquidity through the allocation of special drawing rights (SDRs). The Fund has three broad areas of activity: surveillance, programmes supported by financing arrangements, and technical assistance. Through these, the Fund exercises its responsibility of oversight of the international monetary system and of the code of conduct to which members have subscribed.[6] The members are required to provide the Fund with the necessary information and to enter into consultation over their exchange rate policies when they are requested by the Fund to do so.

[4] The origins of the Fund can be traced to the great depression of the inter-war years. In July 1944, a conference was held in Bretton Woods, New Hampshire, which aimed to form an institution to promote and supervise the international monetary system. The Fund and the World Bank together form the Bretton Woods institutions.

[5] The origin and legal basis of the surveillance function stem from Article IV, section 3(b) of the Articles of Agreement, which states that “the Fund shall exercise firm surveillance over the exchange rate policies of members and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member’s exchange rate policies”. See IMF, Articles of Agreement, Article IV, section 3b, available at <http://www.imf.org/external/pubs/ft/aa/aa04.htm> (18 January 2000).

[6] Leo van Houtven, “Half a century after Bretton Woods: the role of the IMF in the international monetary system”, in A. Bakker, H. Boot, O. Sleijpen and W. Vanthoor, eds., *Monetary Stability Through International Cooperation* (Dordecht, the Netherlands, Kluwer Academic Publishers, 1994) p. 283.

IMF surveillance

The Fund’s surveillance refers to all aspects of analysis and advice concerning the economic situation, policies and prospects of member countries (for the main features of IMF surveillance, see table V.1). The Fund collects the information required for surveillance during regular consultation between the Fund and members (Article IV consultations) as well as through frequent contacts between national authorities and Fund management and staff. It also collects information through discussion held in connection with its multilateral surveillance activities. Because timely surveillance can help prevent or minimize negative externalities as a result of sound policy coordination among members, surveillance can potentially benefit both the international community and individual member States.

The specific activities of surveillance can be classified under the broad headings of information, policy advice and policy coordination. Provision of information, including economic data, can be treated as a public good and, as such, may be undersupplied by markets. Besides, because the Fund is assumed to be neutral with no conflict of interest, unlike governments, it can provide objective information and analysis, especially when the country-specific information is not very positive. Giving policy advice is an offshoot of the expertise it possesses as well as its institutional memory. Finally, the Fund has a role to play in fostering policy coordination owing to its neutrality. It can provide information and analysis of the spillover effects of policies that help policy makers internalize spillovers in their national policy calculus.

Traditionally, there have been two levels of surveillance practised by the Fund: bilateral and multilateral.[7] Bilateral surveillance refers to the Article IV consultations undertaken by the Fund with individual member countries, while multilateral

[7] Lately, with the emergence of regional blocs as single markets, for example the European Union, there has been some limited activity pertaining to regional surveillance. At present, the focus of this level of surveillance is on monetary integration, as the euro was introduced in the market this year. Nonetheless, this does not diminish or remove the Fund’s bilateral surveillance on the 11 individual members of EU.

Table V.1. Purposes of IMF surveillance

Surveillance at IMF has six main features:

Feature	Description
1. Policy advice	The Fund offers advice and proposals as well as serves as a sounding board for policy dilemmas facing a country.
2. Policy coordination and cooperation	The Fund helps policy consultation among groups of countries by providing inputs such as reliable data, forecasts and analysis and the machinery through which policy coordination can take place.
3. Information gathering and dissemination	The Fund maintains databases that are useful for policy formulation, and disseminates information which can benefit private market participants and the general public.
4. Technical assistance and aid	In many developing countries, surveillance is tantamount to providing technical assistance, owing to the scarcity of expertise in macroeconomic policy-making.
5. Identification of vulnerabilities	This is an extension of the information and policy advice role that is relevant in the light of the unsustainable mix of policies of certain countries. In this context, early warnings and policy advice, including on risks in their financial sector, given by the Fund to vulnerable countries play a role in formulating prompt corrective policy measures.
6. Delivering the message	The Fund disseminates, through policy advice, the prevailing consensus of the economics profession to governments and the world.

Source: J. Crow, R. Arriazu and N. Thygesen, "External evaluation of surveillance report", in *External Evaluation of IMF Surveillance* (Washington DC, IMF, 1999), available at <http://www.imf.org/external/pubs/ft/exev/surv/index.htm> (26 January 2000).

surveillance refers to the systemic analysis and forecasting of the world economy, published in the *World Economic Outlook and International Capital Markets Report.* Partly as a result of the debate on the new financial architecture, the Fund has recently focused on developing and/or promoting standards, codes of best practices and transparency reports. These activities have repercussions for its surveillance functions.

Bilateral surveillance

Bilateral surveillance involves monitoring the economic circumstances of the individual members of IMF leading to policy prescription. In the immediate post-war period, IMF was tasked with monitoring the Bretton Woods par value system and encouraging the members to move towards convertibility of the current account. Following the collapse of the Bretton Woods system, the Fund's mandate turned towards surveillance over the exchange rate policies of its members. This level of surveillance focuses more on policy implementation and monitoring as it aims to gather information and provide policy discussion and advice.

The process

An Article IV consultation is divided into three parts.[8] First, the internal process consists of preparing a briefing paper before a Fund mission visits a country. This paper describes the economic situation of the country and includes the views of IMF staff on current policies and on the needed changes. Senior staff and Fund management review the paper to ensure that problems are sorted out in house before the actual review is undertaken.

Second, the mission to the country starts once the briefing paper has been cleared and usually lasts for two weeks. Four or five staff members from the different departments of the Fund form the mission team. Meetings are held with senior and mid-level officials from the finance ministry, central bank and other agencies involved in policy formulation. The staff also meet with representatives of the private sector and the business community. The

[8] See Richard H.R. Harper, "The machinery of policy work", in *Inside the IMF: An Ethnography of Documents, Technology and Organizational Action* (San Diego, California, Academic Press Inc., 1998), pp. 124-125.

purpose of the mission is information-gathering and policy discussion and advice. A concluding meeting is held with the senior officials (Secretary of Finance and Central Bank Governor). Once the mission has been completed, a staff report is prepared, reviewed and sent to the Executive Board.

Lastly, after the Executive Board has discussed the staff report, the Chair (either the Managing Director or Deputy Managing Director) will sum up the views of the Board. This completes the Article IV consultation process.

Following the meeting of the Executive Board, a Public Information Notice (PIN) may be released to the public upon approval of the concerned national authorities. A PIN consists of a factual summary of recent economic developments and a summary of the discussion in the Executive Board. In addition, under the terms of a recently adopted time-bound project, Article IV consultation reports may be released to the public, following their consideration by the Executive Board, if the national authorities so desire.

For most countries, Article IV consultations take place annually. While there have been attempts to reduce the frequency of the consultations for smaller countries on a voluntary basis, in practice countries are reluctant to move to biennial consultations. At present, there are 23 members on a biennial consultation cycle. In financial year 1998/99, the Fund completed 25 Article IV consultations.

Technical aspects

Initially, the scope of the Fund mission was confined to the exchange rate and macroeconomic (monetary and fiscal) policies of a country. Over time, its scope has expanded into several other policy areas, concomitant with increasing global economic integration through trade and capital flows, including capital mobility and capital account convertibility, and resultant interrelationships among countries (external shocks, spillover and contagion effects). The scope of consultations has also been expanded over time in response to the greater understanding of the linkages between macroeconomic policies and outcomes, on the one hand, and structural factors such as the health of financial systems, on the other.

The Fund's main concern is that macroeconomic policies be consistent with a viable external payments situation that is sustainable over time. Its objective is to ensure that countries adjust macroeconomic policies in a timely manner to forestall crises and, in particular, to prevent countries having recourse to balance-of-payments restrictions and controls that are detrimental to the international monetary system. On monetary policy, the main concern of the Fund is usually to keep the level of inflation to a minimum. On fiscal policy, its thrust has been directed at the following areas: making public finances more transparent; making public sector accounts more complete; containing fiscal deficits; developing and clarifying the concept of quasi-fiscal deficit due to, inter alia, central bank operating losses; and analysis of structural and cyclical factors in government finance. In terms of exchange rate policy, surveillance centres on the appropriate exchange rate system and exchange rate levels. Both fixed and flexible exchange rate systems are being allowed by the Fund as long as the country's macroeconomic policy is consistent with the system chosen. Lately, the Fund has been tackling structural and institutional issues, especially in labour markets and financial systems, in addition to the standard macroeconomic ones.

Key economic indicators of member countries typically published in a PIN are given in table V.2.

Table V.2. Indicators used in Public Information Notices

Sector	*Indicators*
Real	Real GDP growth rate, inflation, unemployment, savings, investments
Public finance	Budget deficit, public debt
Money and credit	Money supply growth, domestic credit growth
Interest rates	Short- and long-term rates
Balance of payments	Trade balance, current account, reserves
Exchange rates	Exchange rate regime, nominal rates, real effective rates

However, there are other indicators, such as the debt service ratio, which are frequently used for developing countries. All of these are macro-economic indicators which have relevance to a country's exchange rate and balance-of-payments position. In view of the nature of the crisis in Asia, the Fund, in its assessment of the vulnerability of countries, is placing increased emphasis on measuring contingent liability, the composition of external debt, and forward positions.

Multilateral surveillance

The process

Multilateral surveillance is geared more towards analysis of recent world developments, projections of future development, identification of risks of instability in the international economic system and the proposing of the ensuing policy recommendations. The primary vehicle for the Fund's multilateral surveillance is *World Economic Outlook,* produced twice a year, which provides a comprehensive set of economic forecasts for the world economy. It usually covers the broad areas of the world economic situation, global economic prospects and related policies issues, especially policy stances in industrial countries. There is an emphasis on financial and foreign exchange markets and external payments, financing and debt.

Technical aspects

The forecasts used by IMF are produced by a bottom-up rather than top-down procedure, that is, they are not produced by a single model of the world economy, but rather compiled from forecasts for individual countries by the Fund's area departments. The country projections are prepared on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies, accounting for 90 per cent of world output, the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the Fund's regular Article IV consultations with the member, after reflecting changes in assumptions and global economic conditions.

The focus of multilateral surveillance is on examining the impact of national policies on the global environment. These "environmental" projections are fed back into the forecasting and analysis that underpins the bilateral Article IV consultations. The regular monitoring of key economic developments helps in the assessment of the consistency and sustainability of national policies in the light of developments in the world economy. Monitoring further helps identify situations that warrant policy review and consultations. Special attention is devoted to developments in exchange rates, trade and capital flows, which are the principal elements of international interaction, as well as the broad range of economic policies underlying them.

Regional surveillance

The Fund has engaged in surveillance at the regional level in response to the integration of Europe into a single market, that is, the European Union. Furthermore, the crises in Mexico and Asia have highlighted the need for surveillance at the regional level. A framework is now in place for twice-yearly policy discussions with European Union institutions responsible for common policies in the euro area, including the European Central Bank. Discussions are expected to focus on the common monetary policy, exchange rate implications and the fiscal position of the euro area as a whole. The European Central Bank has been given observer status on the IMF Executive Board. Nonetheless, members of the European Union will continue their Article IV consultation on an annual basis.

The Fund has been active in providing inputs to other regional mechanisms for policy consultations. It has been designated as the technical secretariat to the Manila Framework group. The Fund has also been invited to present economic briefings for the ASEAN Finance Ministers' process (for further details on these initiatives see chapter VI). Similarly, the Fund has contributed inputs to the APEC forum. The Fund's main contribution has been the preparation of background papers; however, these papers do not focus much on regional inter-relationships but rather are drawn from available materials resulting from country-level consultations. The Fund conducts regular discussions with regional entities of a number of currency unions, such as the West African Economic and Monetary Union, the Central African Economic and Monetary Community and the Eastern Caribbean Currency Board.

Other regular statistical publications of the Fund

The Fund produces a number of regular statistical publications covering its member countries, of which the following are the most important:

Balance of Payments Statistics Yearbook: An annual publication covering balance of payments data for about 160 countries and international investment position data for 48 countries, as well as regional and world totals of major balance-of-payments components.

Government Finance Statistics Yearbook: An annual publication providing detailed data on revenue, expenditures, financing and debt of central governments and, when available, data on state and local governments and institutional units of government.

International Financial Statistics: A monthly publication reporting current data on exchange rates, international liquidity, international banking, money and banking, interest rates, prices, production, international transactions, government accounts and national accounts, by country and for regional and world aggregates.

Recent initiatives in crisis prevention: transparency, standards, surveillance and strengthening the financial system

Transparency and standards

Along with other international organizations, national agencies and the private sector, IMF has been active in devising new strategies to contribute to crisis prevention and resolution in the context of the new financial architecture. The initiatives of the Fund have focused on (a) enhancing transparency, standards and surveillance; (b) strengthening financial systems; (c) capital account issues, such as the use of capital controls; (d) involving the private sector in crisis prevention and resolution; and (e) more systemic issues, such as exchange rate regimes. In the context of this chapter, the focus is on the first two categories.

Initiatives to enhance transparency

The Fund, through its Executive Board, has taken important steps to enhance the transparency of its members' policies through encouraging (a) the release of PIN after Article IV consultations; (b) voluntary public release of Article IV staff reports; (c) release of a Statement by the Chairman of the Executive Board after discussions on the use of Fund resources; and (d) publication of letters of intent, memoranda of economic and financial policies, and policy framework papers; as well as of external evaluations of the Fund's surveillance and economic research activities. The public release of the PINs and staff reports on Article IV is designed to inform the markets and policy makers about the economic situation of a country. The above mentioned initiatives will be reviewed in the future along with proposals to expand external reviews of the Fund's operating procedures.

Promotion of international standards

The international community has called upon IMF and other standard-setting agencies to develop standards or codes covering a number of economic and financial areas (see annex V.2), among which data dissemination and good practices for transparency in the fiscal area and in monetary and financial policies are of particular concern to IMF. While the codes and standards are still evolving and are likely to continue to do so, the main challenge is to implement them. To this end, the Fund is extending technical assistance to help countries implement the provisions in the codes.[9]

Standards on data. The hallmark programmes for promoting the best practices in data dissemination are the Special Data Dissemination

[9] The Fund established a standards and codes web page, which provides information on standards in areas of direct operational relevance to the Fund (fiscal, monetary, and financial policy transparency, and banking supervision), a description of progress in developing standards in other areas, links to the web sites of other standard-setting bodies, and experimental reports on observance of standards in selected economies. The web site is accessible at <http://www.imf.org/external/standards/index.htm> (18 January 2000). The Fund established a separate web page for data standards, The Dissemination Standards Bulletin Board, available at <http://dsbb.imf.org> (10 February 2000).

Standard and the General Data Dissemination System. SDDS, which was established by the Executive Board on 29 March 1996, was set up to guide countries that have, or might seek, access to international capital markets in the dissemination of economic and financial data to the public. GDDS, on the other hand, which was established on 19 December 1997, focuses on improving data quality and provides a framework for evaluating the need for data improvements, and guidance and dissemination. GDDS is meant to improve data quality for countries that are not yet in a position to subscribe to SDDS. By the end of 1999, seminars had been held in all regions of the world and virtually all potential GDDS clients participated. Both SDDS and GDDS are expected to enhance the quality and availability of timely and comprehensive economic and financial statistics, and hence contribute to the pursuit of sound macroeconomic policies.

In December 1998, the Executive Board decided to introduce in SDDS a separate category for external debt. Also, in order to strengthen SDDS, it agreed in March 1999 to adopt a prescription for the dissemination of the new template on international reserves and foreign liquidity on a monthly basis with a lag of no more than one month. The transition period for observance of the new standard was one year, up to March 2000. In October 1999, IMF disseminated operational guidelines to assist countries in using the template and to promote data comparability across countries.

SDDS does not directly avert an economic and financial crisis, rather it enhances the transparency of data dissemination to the public and to various authorities, making surveillance and assessment easier for government departments, central banks or any regional monitoring bodies. Moreover, if and when a crisis strikes, policy- and decision-making with regard to solutions would be facilitated by having timely and comprehensive data on hand. Thus, SDDS will serve as an important ingredient in both the prevention and resolution of economic and financial crises.

Other codes. In April 1998, the Interim Committee of IMF adopted a Code of Good Practices on Fiscal Transparency to guide members seeking to increase fiscal transparency, and thereby to enhance the accountability and credibility of fiscal policy as a key component of good governance. The implementation of the Code is on a voluntary basis, but technical assistance is being offered to assist authorities in implementing it.

On 26 September 1999, the Interim Committee adopted the Code of Good Practices on Transparency in Monetary and Financial Policies as a guide to members to increase transparency in the conduct of these policies. The design of the good transparency practices rests on two principles: first, monetary and financial policies can be made more effective if the public knows the goals and instruments of policy and if the authorities make a credible commitment to meeting them; second, good governance calls for central banks and financial agencies to be accountable in areas where monetary and financial authorities are granted a high degree of autonomy.

To foster the adoption of various international standards, in 1999 IMF prepared a number of experimental reports on the observance of standards and codes, which are sometimes referred to as "transparency reports".[10] These reports combine a description of country practice, based on discussions with the relevant national authorities, with independent assessments by Fund staff as to the consistency of those practices in relation to the specified standards. The reports focus mainly on areas of direct operational concern to the Fund, namely, data dissemination, fiscal policy transparency, monetary and financial policy transparency and bank supervision. The Fund is currently preparing another round of experimental reports in collaboration with the World Bank. The round will feature assessments of specific standards in selected countries, rather than a full set of standards for an individual country.

Refocusing surveillance

An external evaluation of the surveillance activities of IMF was undertaken and recommended that the Fund should continue surveillance of its traditional areas, exchange rate and macroeconomic policies, while at the same time placing more importance on the international and regional dimensions of surveillance, the contagion effects, and assessment

[10] Completed reports are available at <http://www.imf.org/external/standards/index.htm> (10 February 2000).

of the financial vulnerability of countries. It should also pay more attention to the banking system and the capital account etc. The Fund intends to put greater focus on debt and reserve management practices as well. The enhancement of the surveillance dovetails with the initiatives to improve transparency and to develop and adopt codes of best practices.

Strengthening financial systems

The Fund, together with other international agencies, has been increasing its efforts to strengthen the financial systems of countries. In the Fund, this has included the development of codes of good practices, as mentioned earlier, as well as the launching in 1999 of the Financial Sector Assessment Programme (FSAP). The main goal of this programme, developed in the context of Article IV consultations and in collaboration with the World Bank, is the preparation and delivery to national authorities of comprehensive assessments of their financial systems. Such assessments are aimed at identifying strengths, vulnerabilities and risks; ascertaining the sector's development and technical assistance needs; assessing observance and implementation of relevant standards, codes and good practices; and designing appropriate policy responses. The focus of the FSAP is on helping governments reduce the likelihood and severity of financial crises and cross border contagion. To date, assessment reports for four countries (Canada, Colombia, Lebanon and South Africa) have been completed and assessments have been initiated for three countries (Cameroon, Estonia and Hungary). Six other countries, including India, have agreed to conduct assessments in the near future.

The Fund, alongside other institutions, is participating in a task force to review the 1988 Basle Capital Accord, by preparing comments on the proposed New Capital Adequacy Framework. In addition, the United Nations Commission on International Trade Law has expressed interest in collaborating with the Fund and the World Bank to promote orderly and effective insolvency systems and to ensure a proper legal environment for financial systems. Finally, the Financial Stability Forum was set up by the G-7 Finance Ministers and Central Bank Governors in February 1999 to coordinate responsibilities for promoting international financial stability more effectively. Its members include the Basle Committee on Banking Supervision, BIS, IMF, the World Bank, IOSCO and IAIS, as well as three representatives (Finance Ministry, Central Bank and supervisory authority) from each of the G-7 countries. It first convened in April 1999 in Washington DC. It has established three working groups, on highly leveraged institutions, capital flows and offshore financial centres.[11]

BANK FOR INTERNATIONAL SETTLEMENTS

BIS, created in 1930, is an institution essentially owned and controlled by central banks. It provides them with a number of highly specialized services. One of its overriding functions is to promote financial stability through international cooperation on sound bank supervision practices, developing standards relating to risk management, gathering and disseminating data and policy analysis.

BIS functions as a forum for forging international monetary and financial cooperation. It also provides central banks with a broad range of financial services for managing their external reserves. It serves as an agent and trustee in the execution of international financial agreements. Finally, it is a centre for monetary and economic research, contributing to a better understanding of international banking, national monetary policies and financial market developments. Since 1994, the Bank's Board of Directors has been drawn from the 11 countries comprising the Group of Ten (G-10), with which BIS has a close association. In 1996 and 1997, nine additional central banks were admitted to membership, including, from the ESCAP region, China; Hong Kong, China; India; Republic of Korea; and Singapore. In 1999, Argentina, Chile, Malaysia and Thailand also became shareholders.

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[11] See IMF, *Progress in Strengthening the Architecture of the International Financial System,* Statement and Report of the Managing Director to the Interim Committee, IMF advance copy (Washington DC, September 1999), pp. 10-12, and the Financial Stability Forum web site, available at <http://www.fsforum.org/> (24 January 2000).

The international stature of BIS was enhanced in the wake of the Asian crisis, which highlighted the strong interrelationship between finance and the real economy. In both the resolution of the crisis and the discussions on the design of a new financial architecture, BIS provided important inputs, including taking a lead in policy analysis and the construction of standards for fostering financial stability.

The process: modalities to promote financial stability

BIS makes an important contribution to international financial stability by ensuring that policy makers, at least central bankers and other regulators, know each other well and have open lines of communication. In addition, the international community (particularly the central banks of the G-10 countries) has found it appropriate to provide bridging loans through BIS to countries in financial difficulties which are awaiting the receipt of funds from IMF, the World Bank or other sources. However, its main contribution to fostering international monetary and financial cooperation towards financial stability involves undertaking analyses for and organizing regular meetings of senior central bank and other officials on key issues of financial policy. These meetings, which are organized under the aegis of one of the committees outlined below, fall into four categories:

(1) Regular consultations among central bank governors and senior officials on conjunctural and monetary issues and on matters affecting financial stability

(2) Meetings of standing committees that formulate standards or recommend best practices to promote financial stability

(3) Meetings involving broader sets of national authorities and international institutions

(4) Meetings centred on technical areas of central bank activities.

To the extent that these activities contribute to exchanges of information and analysis, they should be considered as focused mechanisms for crisis prevention.

In the first category, the central bank governors of the G-10 countries meet regularly to discuss topical issues as well as receive various reports from the Standing Committees. A second set of larger meetings, held on the same day as the G-10 meetings, involves the governors of all BIS shareholding central banks and covers monetary and financial policy issues such as central banks' involvement in the surveillance and supervision of financial institutions; the role of rating agencies in the operation of financial markets; and the design and operation of financial safety nets; the containment of risks posed to the global economy by the Asian crises; as well as the implications of the introduction of the euro. In a third forum, involving central bank governors of the principal industrial and emerging market economies, some of the more important issues discussed have been current account and exchange rate adjustment in the wake of the Asian financial crises; the pace of bank restructuring in emerging markets; and the challenges posed by asset price inflation surrounded by deflationary pressures in goods markets.

BIS provides the secretariat for a number of standing committees[12] working to promote financial stability. The specific modalities pursued at BIS are three-pronged, corresponding to the three pillars of the financial system: financial institutions, financial markets and payment and settlement systems. There is a separate BIS committee dealing with each: the Basle Committee on Banking Supervision (institutions); the Committee on the Global Financial System (formerly the Euro-currency Standing Committee) (market) and the Committee on Payment and Settlement Systems (infrastructure). In general, the meetings are geared towards policy analysis and capacity-building exercises. Included among the tasks of these committees are the design and dissemination of various standards and codes of best practices, of which the Basle Core Principles for

[12] These committees are usually set up by the G-10 central banks and national regulatory authorities, if independent of the central bank. BIS provides them with a secretariat and its offices serve as the location of the meetings of the committees. The secretariat of IAIS is also located at BIS and cooperates closely with the BIS secretariat in supporting the Basle committees.

Effective Banking Supervision constitute a landmark. BIS also collects and monitors financial data and participated actively in establishing the *Joint BIS-IMF-OECD-World Bank Statistics on External Debt.* The following is a more detailed description of the functions of the three main committees.

Basle Committee on Banking Supervision. This Committee provides a forum for discussion on the handling of specific supervisory problems. It coordinates the sharing of supervisory responsibilities among national authorities with respect to banks' foreign establishments, with the aim of ensuring effective supervision of banks' activities worldwide. The Committee also seeks to enhance standards on supervision, especially with regard to solvency, so as to help strengthen the soundness and stability of international banking.

Committee on the Global Financial System. Formerly the Euro-currency Standing Committee, this Committee deals with a series of market-related issues, such as the implications of international debt problems, the evolution of financial market structures, the macroeconomic and prudential implications of derivative instruments, and the collection of new statistical information. Now with a revised mandate, it focuses on the systematic short-term monitoring of global financial system conditions, longer-term analysis of the functioning of financial markets, and the articulation of policy recommendations for the improvement of market functioning and promotion of stability.

Committee on Payment and Settlement Systems. This Committee is concerned with the promotion of robust payment and settlement systems, so as to strengthen financial market infrastructures and reduce systemic risk. Particularly, it is concerned with the reduction of foreign exchange settlement risk, the promotion of greater transparency in securities settlement arrangements, and an improved understanding of the retail payments industry.

In addition to the above activities, BIS engages in a number of ongoing collaborative activities with other financial institutions in helping to redesign the financial architecture. For instance, three working groups composed of members of the Group of 22,[13] set up and backstopped by BIS and IMF, have tackled and made recommendations concerning transparency and accountability, strengthening financial systems and managing international financial crises.

Leverage of the Basle process

BIS does not normally use its own financial resources to promote or finance particular courses of action by its members, unlike other international financial institutions such as IMF, the World Bank and the regional development banks. Rather it organizes and facilitates meetings, and produces research.[14] It also supports the setting of standards, codes of best practices and benchmarks, with the expectation that individual authorities from different countries will adopt these. The value added provided by BIS thus lies in the enhanced capacity and understanding of the national representatives who attend its meetings or read its papers.[15]

International cooperation at BIS rests on the principle of national (state) control; BIS only suggests and advocates policy changes or practices, and does not impose conditionalities. Members of the various committees that meet at BIS negotiate positions among themselves in order to find an agreement that is acceptable across countries as well as to public and private sector agents, and which can be approved by ministers and governors and eventually implemented through national legislation or regulation. While the members of the committees that meet at BIS are mostly from the G-10 countries, agreements reached are often also

[13] Finance ministers and central bank governors from 22 countries with systemically important financial markets, established at the APEC meeting in November 1977 to move forward the reform of the international financial architecture. See IMF, "A Brief Guide to Committees and Groups", available at <http://www.imf.org/external/np/exr/facts/groups.htm> (31 January 2000).

[14] White, "Promoting international financial stability: ..."

[15] This is why countries such as Thailand have decided to buy shares in BIS and so be in a position to participate in the ongoing discussions (*Bangkok Post,* 12 November 1999).

accepted by non-G-10 members as effective global standards. In addition, private rating agencies, IMF and the World Bank play supporting roles in communicating what are deemed to be best practices to the non-G-10 countries. Thus, the general Basle process adheres to the modality that decision-making is left in the hands of nation States, while international organizations are tasked with information dissemination.

Case study: the Basle Committee on Banking Supervision and supervisory practices

Established in 1974, the Basle Committee on Banking Supervision follows the general Basle process. It does not possess any formal supranational supervisory authority as its conclusions do not have legal force. For this reason, central banks are neither compelled, nor required by law, to subject themselves to the decisions of the Committee. It formulates broad supervisory standards and guidelines and recommends statements of best practices in the expectation that individual authorities from different countries will take steps to implement them through arrangements suited to their corresponding national systems. Thus, the Committee encourages convergence towards common standards without detailed uniformity or harmonization of countries' techniques of supervision.

The standard-setting process starts with the identification of the salient issues by the Committee, such as capital requirements, credit risk, market risk or cross-border banking. The Committee seeks the endorsement and commitment for its major initiatives and projects from the central bank governors of the G-10 countries. A working group is then formed, which normally consists of supervisory authorities from the Committee members and selected non-G-10 countries, to formulate the principles and standards with regard to the issue at hand. The drafting of the document is done through a series of meetings of the working group, as well as consultations with a wider group of individual supervisors and regional supervisory groups. Usually, international institutions such as IMF and the World Bank are invited to comment on the work at various intermediate stages. After amendment and finalization of the document, endorsement by the central bank governors of the G-10 countries is sought.[16] Once this has been completed, IMF and the World Bank, together with other institutions and central bank groups, aid in the communication of the document to countries around the world, including non-members of G-10, for implementation. The next step is the assessment of compliance with the principles by the Committee through various methods, such as questionnaires. The process may start over again with the identification of other issues, which may eventually lead to additional papers or amendments of the current document – all with extensive consultation with supervisory groups and international institutions. Among the significant outputs of this Committee are the Basle Capital Accord (1988) and the Basle Core Principles for Effective Banking Supervision (1997).

IMF and the World Bank play an active role in the implementation and assessment of compliance. These two institutions encourage member countries to comply with such best practices, and work with them in assessing compliance. Furthermore, they seek to have countries remedy the identified weakness in their respective banking systems as a result of the assessment. Finally, both IMF and the World Bank, as well as the Financial Stability Institute recently established at BIS, provide technical assistance and training in order to address such weaknesses.

Technical aspects in BIS monitoring: the case of banking supervision

The choice of the variables to be monitored follows from the particular framework for analysis. Thus the variables used by the Committee to monitor banks correspond to the different types of risks identified by the Committee. These variables are described below.

Credit risk. This pertains to the risk of default of a borrower. Credit risk concentration owing to large exposures to a single borrower or to a group of related borrowers is a common cause of banking problems. The Core Principles recommend that banking supervisors set prudential limits to restrict

[16] In some papers, there is no indication as to whether there is endorsement by the Governors of G-10, but important documents containing major principles and standards do state such endorsement.

bank exposures to single borrowers, groups of related borrowers and other significant risk concentrations. These limits are usually expressed in terms of the lending bank's capital and, although they may vary from one bank to another, 25 per cent of capital is usually the most that a bank may extend to a private sector non-bank borrower, or a group of closely related borrowers, without specific supervisory approval. In addition, supervisors are encouraged to monitor the banks' handling of concentrations of risk, wherein banks would report to them if any exposure exceeded a specified limit.

Country risk. A wide variety of factors, such as the economic, social and political environment of the home country, may prevent borrowers of that country from fulfilling their foreign obligations. In a published document,[17] the Committee called for an assessment of these risks, involving the analysis of statistical information of the borrower country. The objective of this analysis would be to project a path for countries' external debt and to forecast their ability to service and repay. This entails examination of the outlook for official reserves and other balance-of-payments items, terms of trade, exchange rates, inflation, record in servicing and repaying external debt, and other relevant factors. Second, there is also a need for proper measurement of country exposure. For this, the Committee recommends a framework within which banks' measurement systems should be set. Finally, banks are also advised to review their appropriate weighting or limits applied to their individual country exposures. Although the Committee does not impose a specific limit or percentage as to the exposure on an individual country, it maintains that banks' limits to exposures must be in relation to the degree of perceived risk. One data set that is of help is the BIS semi-annual report of the maturity distribution of international bank lending.

Market risk and foreign exchange risk. Market risk is defined as the risk of experiencing losses from the on-and-off-balance-sheet positions arising from movements in market prices.[18] In this category are the risks pertaining to interest rate-related instruments and equities in the trading book of a bank; and foreign exchange risk and commodities risk throughout the bank. Hence, in a report on supervision of banks' foreign exchange positions,[19] the Committee states that supervisory authorities must seek to ensure that the risks assumed by banks in their foreign exchange operations are never so large as to constitute a significant threat to either the solvency or liquidity of individual banks. The role of bank management and the establishment of internal control procedures covering foreign exchange business are considered pivotal in ensuring the safety of banks with regard to foreign exchange operations. The Committee leaves the setting of standards of limitation to national supervisors, but stresses the desirability of distinguishing between a bank's total uncovered position in foreign currencies and its open position in individual foreign currencies. In addition, in order to avoid the risk of overtrading, it is suggested that banks keep their foreign exchange turnover approximately in line with the size of their balance sheet. In several major countries, the standard used is the size of the bank's capital base. Finally, in monitoring banks' foreign exchange business, the Committee proposes that the authorities look into two types of information flows: statistical reports from the banks about their foreign exchange operations, and information about events and developments in the foreign exchange market.

Interest rate risk. The exposure of a bank's financial condition to adverse movement in interest rates can have a strong impact on a bank's earnings and capital base, and the economic value of its assets, liabilities and off-balance-sheet instruments. Thus, the Committee recognizes the need for an accurate, informative and timely management information system for measuring and managing interest rate risk exposure, both to inform management and to support compliance with policy. The reports that the Committee recommends should, at a minimum, include the following: (a) summaries of the bank's aggregate exposures; (b) reports demonstrating the bank's compliance with policies and limits; (c) results of stress tests, including those assessing breakdowns in key assumptions and parameters; and

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[17] See BIS, *Management of Bank's International Lending,* available at <http://www.bis.org/publ/bcbsc002.htm #v1d5> (21 January 2000).

[18] See BIS, *Core Principles for Effective Banking Supervision (Basle Core Principles),* available at <http://www.bis.org/publ/bcbsc102.pdf> (18 January 2000).

[19] See *BIS, Supervision of Banks' Foreign Exchange Positions,* available at <http://www.bis.org/publ/bcbsc117.pdf> (21 January 2000).

(d) summaries of the findings of reviews of interest rate risk policies, procedures, and the adequacy of the interest rate risk measurement systems, including any findings of internal and external auditors.[20] Moreover, the bank is asked to submit sufficient and timely information to its supervisors on the range of maturities and currencies in its portfolio.

Liquidity risk. Liquidity risk arises when a bank cannot obtain sufficient funds to meet demand, either by increasing liabilities or by converting assets promptly. When a bank has inadequate liquidity, its profitability can be affected and, in some cases, insufficient liquidity can lead to the insolvency of a bank.[21] The purpose of liquidity management is thus to ensure that a bank is able to meet its contractual commitments fully. The Committee maintains that the elements of strong liquidity management include good management information systems, central liquidity control, analysis of net funding requirements, diversification of funding sources, and contingency planning. The analysis of net funding requirements involves the construction of a maturity ladder and the calculation of cumulative net excess or deficit of funds at selected maturity dates. A bank's net funding requirements are determined by analysing its future cash flows based on assumptions of the future behaviour of assets, liabilities and off-balance-sheet items, and then calculating the cumulative net excess over the time frame for the liquidity assessment. Banks are advised by the Committee to construct a maturity ladder that will be used to compare a bank's future cash inflows with its future cash outflows over a series of specified time periods.

Capital adequacy. Pursuant to the Basle Capital Accord, the Committee also focuses on another important channel for monitoring banks, capital adequacy. The variable associated with this is the capital adequacy ratio, which the Accord has set at 8 per cent capital in relation to risk-weighted assets as the minimum capital adequacy ratio requirement for internationally active banks. One principle in the Basle Core Principles states that banking supervisors ought to set minimum capital requirements for banks and, for international banks, this ratio must meet the minimum standard indicated in the Accord. This figure is perhaps the most widely quoted benchmark of BIS used in assessing the fragility of the financial systems of individual countries. As there were questions about the role of this standard in the run-up to the Asian crisis, the Accord is currently under review and amendments are likely to be adopted in the near future.

The above discussion illustrates the role of the Basle Committee on Banking Supervision with regard to surveillance and the development of early warning systems for banking crises. The Committee has one document focusing on each type of risk, discussing the different ways of managing from which one can gather the variables to be monitored. The documents also highlight the role of the banking supervisors in the development of risk management systems. The setting of standard or benchmark levels with regard to variables such as levels of foreign exchange exposure, levels of liquidity, country exposure etc. are all left to banking supervisors. The exceptions are the minimum capital adequacy ratio requirement (8 per cent), and the risk concentration ratio (25 per cent of capital). The Committee gives only the general framework of the management and procedures of risk assessment to be followed by each banking supervisor. By doing so, BIS is recognizing the autonomy of central banks and other banking supervisors, as well as taking into account the fact that, given the diversity of banks worldwide, the imposition of uniform standards could prove to be ineffective.

Publications of BIS

The BIS data collection exercises started more than 30 years ago with the recognition of the possible monetary implications of the rapid growth of the euro-currency markets. Over the years new issues arose and the need for the reporting of semi-annual international banking data on a fully consolidated basis was established. At the same time, the internationalization and growing scale of global financial market activity saw the need for increased statistical monitoring in the fields of both international banking and international securities financing. Recently, BIS has become involved with the monitoring of activities in the derivatives market.

[20] See BIS, *Principles for the Management of Interest Rate Risk,* available at <http://www.bis.org/publ/bcbs29a.htm> (21 January 2000).

[21] See BIS, *Core Principles for Effective Banking Supervision...*

The data published by BIS are used by central banks for policy-oriented monitoring purposes, and by IMF in the compilation of its *International Financial Statistics.* In addition, the data have proved to be of interest to private-sector market participants. The BIS international database covers three basic areas: international banking; international securities markets; and derivatives and foreign exchange markets.[22] The following are the main regular publications of BIS.

Annual report. The BIS annual report includes a discussion on the financial and banking trends of the world. It also deals with the latest economic developments in the advanced industrial countries, issues such as trade, labour and unemployment, wages and prices, as well as monetary policies of industrial countries, and recent developments in asset markets, foreign exchange markets and international financial markets. The latest report included a discussion on the crisis in emerging markets (Asia, Brazil and the Russian Federation), focusing on recent updates, the progress in restructuring, and their effects on other parts of the world. Discussions are backed up by statistical information, mostly at the macroeconomic level. The focus of the activities of BIS for the past year is also reported. In a concluding chapter, policy ideas are promulgated to promote both macroeconomic and financial stability in the light of policies adopted by major countries and their economic and financial experiences during the past year.

Quarterly review: International Banking and Financial Market Developments. This publication reports the quarterly developments in international banking and financial markets, particularly the international securities markets and the derivatives markets. It assesses the current situation in these markets through analyses of movements of key variables such as interest rates, exchange rates, inflation, and yield differentials, as well as international bank and securities financing and international debt securities financing. The countries in focus are usually Japan, the euro area countries (taken as a whole), the United Kingdom and the United States.

[22] A description of the sources, compilation, transformation of data, and outputs is given in detail in *The BIS Statistics on International Banking and Financial Market Activity,* available at <http://www.bis.org/publ/meth06.pdf> (18 January 2000).

Consolidated International Banking Statistics. This publication is composed of semi-annual consolidated statistics on the maturity, sectoral and nationality distribution of international bank lending. Variables such as international bank lending (to Asia, Latin America and Eastern Europe) and international claims are broken down into maturity, sector and nationality. The data in this report are also included in the joint BIS-IMF-OECD-World Bank quarterly statistical release on external debt.

Recent BIS initiatives in surveillance and crisis-prevention measures

The Asian financial crisis and its global effects highlighted the need to understand the risks to financial stability better. It seems to be clear that reliance on self-regulation or on market discipline, while necessary, is not sufficient. By way of responding to this need, there were efforts to discuss in meetings among central bank governors such issues as the containment of the risks facing the global economy and the necessary adjustments needed in the current account, exchange rate and bank restructuring. While the BIS meetings have traditionally focused on events in the G-10 countries, an increasing number now focus on macroeconomic developments in emerging markets as well.

BIS has undertaken several measures in response to the crisis, as outlined below.

Enhancing transparency, data collection and dissemination

The Committee on the Global Financial System has often stressed that transparency in data is very important in crisis prevention. It has taken steps to improve the timeliness, quality and coverage of BIS international consolidated banking statistics. The following recent additions to the regular publications of BIS are initiatives of the Committee to enhance transparency and to improve the quality of data.

Joint BIS-IMF-OECD-World Bank Statistics on External Debt. First published in March 1999, these

statistics are a product of the Inter-Agency Task Force on Finance Statistics.[23] They bring together data, currently compiled and published separately by the contributing international agencies, on components of the external debt of 176 developing and transition economies, and their international reserve assets. The data are mostly from creditor and market sources, but also include information provided by debtor countries.[24] Particular emphasis is placed on debt due within a year. The latest release incorporates multilateral claims, including those of the African Development Bank, Asian Development Bank and Inter-American Development Bank. Moreover, there is a new series showing claims of debtor country residents on banks in BIS reporting countries. The different data series (such as bank loans, debt securities issued abroad, Brady bonds, non-bank trade credits, multilateral claims, official bilateral loans etc.) come from different sources, such as IMF, the World Bank, BIS, OECD or the development banks mentioned. Differences remain between the series in their coverage, frequency and the time lag before publication, and the data do not yet provide a completely comprehensive and consistent measure of total external debt in each country. Nevertheless, this set of statistics brings together, for the first time, the best international comparative data currently available on external debt. The organizations collaborating on these statistics are working to improve their collection systems and to gradually improve their content in terms of quality, coverage, frequency and timeliness, as part of more general efforts towards greater transparency.[25]

The Global OTC Derivatives Market. This semi-annual statistical publication, first published in December 1998, covers the global over-the-counter derivatives market. Included are the notional amounts and gross market values outstanding and the worldwide consolidated over-the-counter derivatives exposure of major banks and dealers in the G-10 countries. They cover the four main categories of market risk: foreign exchange, interest rate, equity and commodity.[26]

Central Bank Survey of Foreign Exchange and Derivatives Market Activity. This triennial survey, which covers 43 countries, focuses on turnovers in traditional foreign exchange market instruments (that is, spot, outright forwards and foreign exchange swaps), as well as turnover, notional amounts outstanding and market values of derivative instruments. “This survey also serves as a benchmark for the new semi-annual derivatives market statistics introduced at end-June 1998, and aimed at tracking the development of open positions... in the global over-the-counter derivatives markets over time.”[27]

The aforementioned reports do not recommend policies to be followed by individual banks (this task is left for central banks at the national or regional level), nor do they warn banks of critical levels in their banking operations based on statistical data. Rather, these publications merely report current developments within the three areas covered by the database (international banking, international securities markets, and derivatives and foreign exchange markets), with a thorough analysis of data trends.

In addition, the Committee, in October 1998, published a template for the comprehensive disclosure of official foreign exchange reserves and potential drains on them. The objective behind this was to remedy shortcomings in existing information regarding the on-and-off-balance-sheet activities of central banks and other public sector entities.

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[23] The Inter-Agency Task Force on Finance Statistics is one of the inter-agency task forces endorsed by the United Nations Statistical Commission and the Administrative Committee on Coordination Subcommittee on Statistical Activities, and was set up in 1992. The Task Force is chaired by IMF and includes representatives of BIS, IMF, OECD and the World Bank, as well as the European Central Bank, the European Statistical Office and the United Nations.

[24] Efforts are being made to understand better the reasons for the differences between creditor-based debt statistics and those provided by debtor countries.

[25] For more details, see *Joint BIS-IMF-OECD-World Bank Statistics on External Debt,* available at <www.bis.org/publ/r_db9909.htm> (18 January 2000).

[26] See, for example, *The Global OTC Derivative Market at end-December 1998,* available at <www.bis.org/publ/otc_hy9906.htm> (18 January 2000).

[27] See BIS, “Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 1998”, press release of 10 May 1999, available at <www.bis.org/press/p990510.htm> (18 January 2000).

Establishing standards and best practices

Revisions to the Basle Capital Accord

During the past two years, the Committee on Banking Supervision has conducted a thorough review of the Basle Capital Accord and is now in the process of receiving comments on a consultative paper of revisions that it has proposed in order to take into account recent developments in the financial markets. The objectives of the revision are continued promotion of safety and soundness in the financial system; continued enhancement of competitive equality among banks; a more comprehensive approach to addressing risks; and a continued focus on internationally active banks, although its principles should be applicable to all types of banks. A definitive accord or new framework should be ready in 2000.

Core Principles Methodology

In order to promote the full implementation of the Basle Core Principles for Effective Banking Supervision, the Committee perceived the need to make an assessment of the extent of current compliance with the Principles among countries. This exercise could help identify weaknesses in the existing system of supervision and regulation, and could form a basis for remedial measures by government authorities and bank supervisors. In April 1998, the Committee initiated a survey through a questionnaire distributed to about 140 countries. Supervisors were asked to undertake a rigorous assessment of their supervisory systems. More than 120 countries complied with the self-assessments with varying levels of quality. At the same time, IMF and the World Bank conducted their own review of compliance in several countries at the countries' request. Such assessments provided the opportunity to test the applicability, clarity and completeness of the Core Principles. These preliminary reviews of compliance, by the Committee itself as well as those conducted by IMF and the World Bank, demonstrated the need to develop a uniform assessment methodology.

As a consequence, at its meeting in October 1998, the Basle Committee decided to produce a document, *The Core Principles Methodology,* to be used in compliance assessments.[28] An ad hoc working group was formed composed of representatives of the member institutions of the Committee, IMF and the World Bank. Consultations were also conducted with the Core Principles Liaison Group of G-10 and non-G-10 senior supervisors, as well as representatives of IMF and the World Bank. The document describes under what conditions assessments should be made, as well as the preconditions for effective banking supervision that should be taken into account when forming an assessment. It also raises considerations regarding the conduct of assessment (such as the access to relevant information) and the compilation and presentation of results. More importantly, it enumerates all significant criteria that are relevant for compliance. Two categories of criteria are used: essential criteria and additional criteria. The essential criteria are those elements that should generally be present in individual countries in order for supervision to be considered effective and thus achieve full compliance with a Principle, while the additional criteria are the elements that further strengthen supervision, which all countries should strive to implement. The essential and additional criteria are drawn from the Core Principles document and related Basle Committee papers.

Supervisory lessons to be drawn from the Asian crisis

In the aftermath of the Asian crisis, the Committee on Banking Supervision formed a working group to study the possible lessons that could be drawn from the crisis for the benefit of the G-10 creditor banks and their supervisors. It focused on two major issues: the extent to which the Basle solvency rules played a role in the size and type of banks' exposure to the Asian countries; and the possible lessons for supervisors of creditor banks on the way these banks manage their country risk profiles. The recommendations of the group included the informal sharing between supervisors of approaches to the measurement and management of risk, and the support to the regular publication of

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[28] See BIS, *The Core Principles Methodology,* available at <http://www.bis.org/publ/bcbs61.htm> (21 January 2000).

BIS reports on exposures by lending countries. They also included strengthening the role of the Board of Directors and senior management of an individual bank in establishing and monitoring compliance with policies and procedures; improving the measurement and monitoring of country risk; and recognizing and measuring the interaction among different risks through stress testing and scenario analysis. Finally, the group also identified three major issues regarding the Core Principles for debtor banks in relation to the Asian crisis: (a) foreign currency liquidity management: the need for guidelines on liquidity management in stress conditions; and closer follow-up of liquidity management; (b) credit risk management: the importance of knowing the customer's business, the risks associated with directed loan activity, and issues of guarantees and collateral; and (c) the Basle Capital Accord as a minimum standard: the need to tailor levels of capital adequacy to the level of development of banks in a country.[29]

Providing inputs to efforts to reform the international financial architecture

From April 1998 to March 1999, three reports on the international financial architecture were completed by three working groups composed of representatives of the central banks and finance ministries of industrial countries and emerging market economies.[30] The Working Group on Transparency and Accountability considered the contributions that transparency and accountability could make to improvements in economic performance, as well as the nature of the information needed to give effect to those improvements. The Working Group on International Financial Crises formulated new principles and reviewed existing policies to avoid international financial crises and facilitate the early, cooperative resolution of crises that might occur in the future. Finally, the Working Group on Strengthening Financial Systems worked on principles and policies to foster the development of an efficient financial system and enhance cooperation among national and international institutions concerned with financial stability.

Setting up new regional and global arrangements

In July 1998, BIS established the Representative Office for Asia and the Pacific in Hong Kong, China. It is hoped that the office will further enhance information exchange and cooperation among central banks in the region, and between them and central banks in the rest of the world. BIS also held a regional conference in Asia. Both of these moves reflect the importance of the Asian financial system in the monitoring function of BIS.

Furthermore, the Financial Stability Institute was set up by BIS in February 1999 in order to strengthen financial systems worldwide, through better and more independent supervision of banking and implementation of the Core Principles. The organization of seminars and training programmes, which also promote the interaction of supervisors from emerging markets and industrial countries, is the means to accomplish this goal.

INSTITUTE OF INTERNATIONAL FINANCE

IIF was created in 1983 by 38 banks of the leading industrialized countries as a response to the international debt crisis of the early 1980s. It is now a global association of financial institutions. Its members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies, export credit agencies, multinational companies, trading companies, investment management firms, and multilateral agencies. More than half of its members are European-based financial institutions, though there has been a steady rise in representation from the leading financial institutions in emerging market countries. The growth of the Institute can be seen in its present membership, numbering more than 300 and headquartered in more than 50 countries.

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[29] See BIS, *Supervisory Lessons to be Drawn from the Asian Crisis,* available at <http://www.bis.org/publ/bcbs_wp2.htm> (21 January 2000).

[30] BIS, *69th Annual Report* (7 June 1999), available at <http://www.bis.org/publ/ar99e.htm> (21 January 2000).

Modalities of crisis prevention and early warning

The Institute lists three primary goals which reflect its monitoring functions. First, it seeks to support members' risk management, asset allocation, and business development in emerging markets. To carry this out, the Institute provides its members with quality reporting, data, and analysis of economic and financial developments and prospects in emerging market economies. Second, it aims to serve as a forum for engaging the private financial community in discussions with finance ministers, central bank governors, IMF, the World Bank and other multilateral agencies. These discussions focus on preventing financial crises in emerging market economies and mitigating political risks for private sector infrastructure projects. Lastly, it endeavours to provide a vehicle for the exchange of information and views on global financial supervision issues and to advance consensus on them among important regulatory institutions.

By engaging in policy research and analysis, and maintaining databases on emerging markets, the Institute is capable of helping its members with the following:

- Assess risk and manage exposure in emerging market economies
- Identify and understand key trends in emerging markets finance
- Anticipate the effects of economic policy decisions on debt and equity markets
- Develop business opportunities

The Institute also advises clients on emerging markets.

Information gathering and analysis

The Institute engages in information gathering, including the fielding of IIF economists on missions to emerging market economies to discuss policies directly with top government officials and representatives of private financial institutions and the business community. Another part of the Institute's economic work is the analysis of emerging markets. Its research output includes the following:

- *Economic Reports* offer in-depth analysis of the economic conditions, policies and prospects of individual economies; developments in domestic capital markets; and access to external finance.
- *Monthly Economic Reviews,* issued for approximately 25 markets, provide the latest data and analysis on key financial indicators and economic developments.
- *Special Economic Briefings* are issued periodically on selected economies. The notes are designed for senior bankers and executives and include special sections on key issues and the economic outlook for these economies. They are issued in connection with the annual meetings of IMF, the World Bank and the regional development banks.
- *Key Indicators: Selected Emerging Market Economies,* published three times a year, give senior bankers and analysts a handy reference to facilitate comparison of important data across emerging markets. This publication presents over 20 economic and financial indicators on approximately 20 emerging market economies, with special analysis of six to eight especially interesting economies in each issue, including a few that are undergoing difficulties.

An important aim of the Institute has been to improve access to timely and accurate data on emerging market economies. A comprehensive database incorporating time series data on a large number of variables is maintained for each of the economies monitored by the Institute. The database includes historical data and projections of macroeconomic performance, balance of payments and external financing.

The Institute also publishes reports on regional and global economic and financial issues of current interest. Among these reports are the following:

- *Near-term Prospects for Emerging Market Economies* summarizes developments and key changes in financing prospects for major emerging market economies, including the composition and direction of

capital flows and the role of bond, equity and debt financing. It also provides an outlook on the global economy, including interest rates, exchange rates, commodity prices and world trade growth, as a framework for assessing economic developments in emerging markets.

- *Comparative Statistics for Emerging Market Economies* is a compilation of economic and financial data on major developing countries for the 10 most recent years.

In assessing countries, the Institute looks at a large number of indicators with respect to both external and domestic sectors. These include short-term debt, the participation of residents in external flows, the overall structure of capital inflows with an eye on the potential for reversal, the importance of derivatives, credit and money growth, the quality of banking and financial sector regulations and supervision, real estate valuation, problem loans, and the profitability of the financial sector and its exposure to exchange rate policies and the fiscal situation. The quantitative indicators are complemented by country-specific qualitative analyses.

Data standards

To improve data quality, in September 1995 the Institute published a set of data standards for emerging market economies *(Improving Standards for Data Release by Emerging Market Economies).* Furthermore, in April 1996 it issued a follow-up assessment of actual country practices in meeting these standards (*Data Release Standards for Emerging Market Economies: An Assessment of Country Practices)* and an update of this review in April 1997. A working group reviewed these standards and recommended a number of changes, which the Institute adopted. These were published in March 1999 *(Report of the Working Group on Transparency in Emerging Market Finance).*

Briefings and advice

The staff of the Institute also prepare briefings and presentations for members in financial centres, provide special country briefings on principal economies during the regular meetings of IIF and provide similar briefings timed to coincide with the annual meetings of the regional and multilateral development banks, IMF and the World Bank.

The Institute is uniquely positioned to monitor and serve as a link between the private sector and the public sector, as seen by its establishment of the Steering Committee on Emerging Market Finance, a high-level committee of senior executives of the world's leading private financial institutions, to guide four working groups and a task force focusing on key issues related to preventing and resolving financial crises in emerging markets. Contact between these groups and official bodies undertaking similar work has resulted in the release of working group reports. In addition, discussions of specific issues have been organized by the Institute with finance ministers and central bank governors from major industrial and emerging market economies and with senior managers at IMF, the World Bank and the regional development banks.

Another part of the Institute's economic work involves global banking and regulatory issues. The Institute monitors and analyses how global trends in industry and the supervisory and regulatory framework affect its members.[31] It offers financial firms both a unique venue for exchanging views on global financial issues and a voice in the public policy debate on key supervisory issues. In the early 1990s, the Institute was instrumental in forging models-based market regulatory capital rules. It also

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[31] The Institute's contributions are the following:

- It provides independent research and analysis on key global financial policy and supervisory/regulatory topics, through the *Banking Department Newsletter* and *Financial Law and Regulation Report*
- Consensus-building at the meetings of the Institute's task forces and working groups
- Dissemination of reports (for example, *Recommendations for Revising the Regulatory Capital Rules for Credit Risk; Year 2000 Checklist: A Guide for Financial Firms;* and *Report of the Task Force on Conglomerate Supervision)* to the members, public authorities and the media
- Informal discussions through the Basle Committee on Banking Supervision and the Joint Forum on Financial Conglomerates

developed an approach for disclosing derivatives-related credit exposures. The Institute is currently taking a key role in shaping industry consensus on changes to be made in the current guidelines of the Basle Capital Adequacy Accord. The Institute also brings together bank executives in emerging market regions once a year to discuss important issues of current interest.

Technical aspects

Basically, the Institute's monitoring function is through the dissemination of economic reports, which come out once to three times a week. Each contains an in-depth analysis of the economic conditions and policies of the economy or region, developments in domestic capital markets, and its access to external finance. The reports are backed up by a statistical databank. The Institute also publishes a monthly review, which gives a summary of the latest data and analysis on economic developments and financial indicators for the principal emerging market economies. Each issue is introduced by an overview that focuses on the key trends and issues in emerging markets[32] during the past month.

The other works of the Institute include *Capital Flows to Emerging Market Economies,* which comes out three times a year and contains an analysis of developments in the international capital markets and the outlook for financial flows to emerging market economies, and *Survey of Debt Restructuring,* which is issued twice a year, and contains a brief description of restructuring arrangements with commercial banks and official creditors, presented country by country in chronological order.

Recent initiatives in crisis prevention

Since the Mexican crisis of the early 1990s, IIF has made substantial improvements in data dissemination, but the recent financial crises have shown the continuing gaps in the availability of relevant information. Beginning in the fall of 1999, the *Monthly Economic Review* includes each quarter a supplementary set of economies, in addition to the core of 20-25 economies covered monthly. This initiative clearly reveals the intent of IIF to monitor more emerging markets. It has also published a number of research papers that deal with the risks of investing in emerging markets.[33]

In 1998, IIF formed the Working Group on Transparency in Emerging Markets Finance. The Group's recommendations, released in a report in March 1999, fall into four main areas: standards for macroeconomic data transparency for emerging market economies; the desirability of improved disclosure by private sector suppliers of capital; the need for further improvements in disclosure by the multilateral official financial institutions, including IMF; and the need for better information on the health of the financial sector in emerging market economies.[34] The revised IIF data standards are grouped into three areas: national accounts, monetary accounts and fiscal accounts. Its standards are comparable with SDDS of IMF. In general, the Working Group recommends a stricter and more forceful implementation of the standards.

IIF also formed the Task Force on Risk Assessment, which released its report in March 1999; it proposed risk management practices for the private sector and policy recommendations for international financial organizations, in the light of the recent financial crises. The Task Force also sought to articulate risk management experiences among groups of leading financial institutions.[35]

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[32] The economies from the ESCAP region that are included are China; Hong Kong, China; India; Indonesia; Malaysia; Philippines; Republic of Korea; and Thailand.

[33] These papers include the following: *Spreads and Risk in Emerging Markets Lending,* No. 97-1 (December 1997); *IMF-supported Adjustment Programs in the East Asian Financial Crisis,* No. 98-1 (May 1998), and *Impact of the East Asian Financial Crisis on Trade of Industrial and Emerging Market Economies,* No. 98-2 (June 1998), available at <http://www.iif.com/public.htm> (31 January 2000).

[34] IIF, *Report of the Working Group on Transparency in Emerging Markets Finance* (March 1999), p. 1, available at <http://www.iif.com/descriptions.htm> (21 January 2000).

[35] IIF, *Report of the Task Force on Risk Assessment* (March 1999), pp. 1-7, available at <http://www.iif.com/descriptions.htm> (21 January 2000).

CREDIT RATING AGENCIES

Private credit rating agencies provide another way of assessing country vulnerability. There are three major international firms: Standard & Poor's, Moody's and Fitch IBCA, as well as some more regional or domestic ones, such as the Japan Bond Research Institute, which rates bond issues in Asia. These provide assessments of both sovereign (government) and private sector credit risk. These agencies rate credit risk on a wide variety of credit instruments and issuers (both public and private sector) of bonds, debt etc. The process of establishing these ratings is in the spirit of monitoring and surveillance operations. While there is some question of their use as early warnings, the ratings should certainly be useful as inputs into monitoring and surveillance activities.

The rating agencies failed to predict the approaching problems in the Asian banking and financial sectors. Although their misinterpretation of signals[36] might have weakened their credibility, in fact their potential influence was increased to an almost quasi-official standing in the proposed revision of the Basle Capital Adequacy Rules released in June 1999. According to the new proposal, credit rating agencies were to be granted a dominant role in banks' internal credit risk evaluation processes. While this proposal has not been welcomed by many, including the rating agencies themselves, it justifies a closer look at the early warning capabilities of credit rating agencies.

In principle, rating agencies have some important advantages over IMF. While they may have less access to data and engage in less intensive discussion with governments, they have the advantage that they can reflect market perceptions about government policies and credibility to a much greater extent. Rating agency reports are updated more frequently to reflect sudden developments and provide a more continuous flow of information in a fast-changing world. Finally, rating agency reports grade countries on an ordinal scale that enables frequent adjustment to reflect marginal changes in the assessment of risk factors, even when the change is small. This is a potentially important advantage, and there are likely to be more frequent adjustments as the rating agencies gain experience.

It is generally not well perceived that sovereign ratings are a relatively recent phenomenon and in fact account for a minor portion of the ratings business income; most of their business remains in corporate ratings. This argues favourably for the objectivity of the rating agencies with respect to country risk. It suggests that there does not exist a significant incentive for rating agencies to either favour or be biased against a particular country. Moreover, an agency's reputation could suffer adversely if its ratings of a sovereign were to be frequently out of line with the market experience of either public or private creditors of that country.

There are quite a few regional or national ratings agencies.[37] In contrast with the three major international agencies mentioned earlier, many of these regional or national rating agencies have links with their respective governments (or may have had, in that they were set up or mandated by a government body). Thus the degree of independence of some of these may be suspect. This may account in part also for the gap between the ratings by regional/national agencies and those of the three majors for the same entities.

It is worthy of note that the members of ASEAN established the ASEAN Forum of Credit Rating Agencies in 1993 and the countries involved have been cooperating with each other to improve methodology and to harmonize standards.

Ratings as an early warning system

Any crisis is likely to impair a country's ability to service debt obligations, and this should be reflected in a deterioration of the country's sovereign rating. If the ratings agencies are quick to recognize the weakening in fundamentals, then the downgrading of credit rating might even precede the onset of

[36] Fitch IBCA admitted: "We used to think that a high proportion of short-term debt was a worry only with highly indebted sovereigns. We were wrong." (*Financial Times,* 14 January 1998).

[37] For example, India and the Republic of Korea have three each, Malaysia has two, and China, Indonesia, Pakistan, Philippines and Thailand have one rating agency each. Meanwhile, Japan has had a 24-year record of experience in rating, the third longest following the United States and Canada.

crisis and serve as a signal. In practice, however, like most of the concerned institutions, the ratings agencies missed calling the Asian crisis. Ironically, they may have contributed to the crisis by maintaining high credit ratings which may have encouraged large capital inflows until the very last minute. Then, by announcing a sequence of quick downgrading within a very short time after the crisis broke, they may have signalled a continuous deterioration which likely added to the sense of panic. As shown in table V.3, Thailand and the Republic of Korea were still rated "Investment grade" in June 1997, the eve of the crisis. It was not until September-October 1997, when the crisis was already in full swing, that these countries were downgraded. The ratings agencies also seem not to have anticipated the severity of the crisis, downgrading these countries by the largest number of notches only in December 1997 or January 1998.

None of the major studies have yet tested the ratings agencies' performance as a leading indicator of a currency crisis. No doubt this is due in part to the ratings not being generally available except to

Table V.3. Ratings for three Asian countries during the crisis

Indonesia					
Moody's			*Standard & Poor's*		
Date	*Rating*	*Change*	*Date*	*Rating*	*Change*
25/6/97	Baa3	–	25/6/97	BBB	–
27/12/97	Ba1	–1	10/10/97	BBB–	–1
9/1/98	B2	–5	31/12/97	BB+	–2
			9/1/98	BB	–3
			27/1/98	B	–6
Republic of Korea					
Moody's			*Fitch IBCA*		
Date	*Rating*	*Change*	*Date*	*Rating*	*Change*
25/6/97	A1	–	25/6/97	AA–	–
27/11/97	A3	–2	11/11/97	A+	–1
10/12/97	Baa2	–4	26/11/97	A	–2
21/12/97	Ba1	–6	11/12/97	BBB–	–6
			23/12/97	B–	–12
Thailand					
Moody's			*Standard & Poor's*		
Date	*Rating*	*Change*	*Date*	*Rating*	*Change*
25/6/97	A3	–	25/6/97	A	–
1/10/97	Baa1	–1	3/9/97	A–	–1
27/11/97	Baa3	–3	24/10/97	BBB	–3
21/12/97	Ba1	–4	8/1/98	BBB–	–4

Source: "Credit ratings and the East Asian financial crisis", a presentation by Frank Packer at the Workshop on Economic Monitoring of Financial Systems in East and South-East Asia, organized by the ADB Institute and PECC Manila, 25-26 June 1998.

Note: Change is measured by the number of rating steps between the former and the new rating. A negative sign shows a downgrading.

subscribers of the ratings agencies. Therefore there is no empirical basis on which to judge their suitability for use in early warning systems. Nevertheless, they should be useful at least as a measure of an economy's vulnerability.

Standard & Poor's and Moody's have roughly corresponding ratings, though they differ in the symbols used. It has been found that they do not deviate too much from each other in their ratings.[38] Disagreements on a rating will be by a notch on the scale in most cases. The high degree of correlation found suggests that both agencies do in fact look at very similar macroeconomic factors (though they may weigh them differently) in coming up with a rating for a particular sovereign.

Standard & Poor's rating approach. In its sovereign credit ratings primer, Standard & Poor's confirms[39] these findings and notes that there is no exact formula for determining ratings. Moreover, Standard & Poor's readily admits that its procedure incorporates qualitative aspects as well. The broad categories in table V.4 show a close correspondence to the usual macroeconomic variables, with the additional category of "Political risk".

Moody's rating approach. Moody's tends to use a more general set of indicators. First, the

[38] Richard Cantor and Frank Packer, "Determinants and impact of sovereign credit ratings", *Economic Policy Review of the Federal Reserve Bank of New York* (New York, October 1996). The explanatory variables were per capita income, GDP growth, inflation, fiscal balance, external balance, external debt, and economic development (proxied by indicator for whether or not a country is industrialized).

[39] Standard & Poor's, "Sovereign credit ratings: A primer", *Sovereign Ratings Service* (December 1998), p. 2.

Table V.4. Standard & Poor's sovereign ratings methodology profile

Political risk
- Form of government and adaptability of political institutions
- Extent of popular participation
- Orderliness of leadership succession
- Degree of consensus on economic policy objectives
- Integration in global trade and financial system
- Internal and external security risks

Income and economic structure
- Living standards, income, and wealth distribution
- Market versus non-market economy
- Resource endowments and degree of diversification

Economic growth prospects
- Size and composition of savings and investment
- Rate and pattern of economic growth

Fiscal flexibility
- General government operating and total budget balances
- Tax competitiveness and tax-raising flexibility
- Spending pressures

Public debt burden
- General government financial assets
- Public debt and interest burden
- Currency composition and structure of public debt
- Pension liabilities
- Banking, corporate, other contingent liabilities

Price stability
- Trends in price inflation
- Rates of money and credit growth
- Exchange rate policy
- Degree of central bank autonomy

Balance of payments flexibility
- Impact of fiscal and monetary policies on external accounts
- Structure of the current account
- Composition of capital flows

External debt and liquidity
- Size and currency composition of public external debt
- Importance of banks and other public and private entities as contingent liabilities of the sovereign
- Maturity structure and debt service burden
- Level and composition of reserves and other public external assets
- Debt service track record

Source: Standard & Poor's, "Sovereign credit ratings: a primer", *Sovereign Ratings Service* (December 1998), p. 2.

qualitative aspect is underlined. While quantification is integral to Moody's rating analysis, particularly since it provides an objective and factual starting point for each rating committee's analytical discussion, ratings are not based on a defined set of financial ratios or a computer model. Rather, they are the product of a comprehensive analysis of each individual bond/debt issue and issuer by experienced, well-informed credit analysts. Second, their analytical focus is on fundamental factors that will drive each issuer's long-term ability to meet debt payments, such as a change in management strategy or regulatory trends. Third, their analysis focuses on an assessment of the level and predictability of an issuer's future cash generation in relation to its commitments to repay debtholders. Their main emphasis throughout the rating analysis is on understanding strategic factors likely to support future cash flow, while identifying critical factors that will inhibit it. The issuer's capacity to respond favourably to uncertainty is also key. Generally, the greater the predictability of an issuer's cash flow and the larger the cushion supporting anticipated debt payments, the higher the rating will be. Fourth, Moody's ratings do not incorporate a single, internally consistent economic forecast but aim rather to measure the issuer's ability to meet debt obligations against economic scenarios which appear reasonably adverse to the issuer's specific circumstances. Last but not least, Moody's analysts take into account the different accounting systems which exist. In examining financial data, Moody's focuses on understanding both the economic reality of the underlying transactions and how differences in accounting conventions may or may not influence true economic values. However, it is important to recognize that Moody's ratings are intended only to measure risk of credit loss. They are not intended to measure other risks in fixed-income investment, such as market risk.

Fitch IBCA approach. The sovereign rating methodology of Fitch IBCA draws on the recent instances of default and near-default to establish a range of key leading indicators of distress. These are incorporated in a risk model that gives a percentage score to sovereign borrowers, which is then converted into long-term ratings. There is also a separate short-term risk model that analyses the prospects of timely repayment within the next year, which highlights the importance of liquidity factors.

Recent initiatives after the crisis

In the aftermath of the crisis, the ratings agencies have also done a considerable amount of self-examination. Sovereign ratings are relatively new and the demand for them did not really take off until the 1980s. Consequently, agencies are still building their capabilities in this area, and strengthening their personnel and data collection systems to better address the drawbacks noticed during the last two years.

In particular, Standard & Poor's has launched a new product that grew out of the Asian crisis: a financial system stress rating. The latest survey on financial system stress, published in May 1999,[40] covered 62 countries, 11 of which are in the ESCAP region. Basically, the survey tries to monitor the degree of leverage within an economy. It uses four leading indicators (level and rate of credit growth; level of private sector debt; level and rate of increase of asset prices; and level and rate of growth of net external liabilities) to predict the likelihood of coming credit disturbances. While these indicators emit signals on potential financial vulnerabilities, they do not measure the extent of the problem or the degree of stress a financial system is undergoing. In order to obtain some indication of the level of stress, Standard & Poor's uses estimates of the potential level of the gross problematic assets of a financial system (calculated at its worst-case scenario of recession), expressed as a percentage of domestic credit to the private sector and non-financial public enterprises. This indicator simply measures the extent of assets that can turn bad in the face of undesirable events such as a recession.

OTHER REVIEW EXERCISES

There are many other reviews of economic development in the Asian and Pacific region undertaken by a variety of institutions, all of which contribute to monitoring exercises by collating, analysing and commenting on trends and events and issuing warnings on potential problems. Some of these are undertaken at the global level, where the developments in the countries of Asia and the Pacific are

[40] See Standard & Poor's, "Global financial system stress: 24 show adverse trends in credit quality", *Sorvereign Ratings Service* (May 1999).

compared and contrasted with those in other regions. Examples of these that are produced by international organizations include the United Nations *World Economic Survey,* the UNCTAD *Trade and Development Report,* and the World Bank *Global Development Finance* and *Global Economic Prospects and the Developing Countries.* Each of these annual publications includes a survey of recent developments, sometimes at the country level and sometimes by groupings of countries, in their particular areas of interest, and they all also include an analysis of some important emerging issue at the global level. The OECD *Economic Outlook,* which monitors economic developments and policies in OECD member countries and is released twice a year, also covers some countries from the Asian and Pacific region (Australia, Japan, New Zealand and the Republic of Korea). In addition, there are monitoring exercises produced by research centres and universities in the private sector, such as the annual country surveys of the Economic Intelligence Unit of *The Economist,* which undertake an in-depth and critical review of developments, policies and future prospects.

At the regional level, there are two main publications from intergovernmental organizations which cover the entire region, the ADB *Asian Development Outlook* and the ESCAP *Economic and Social Survey of Asia and the Pacific.* Both of these undertake monitoring-type exercises and provide commentary and analysis of events, policies and special issues of importance to the region. There are also publications which cover more restricted groups of countries through subregional organizations or through private companies, as well as many government and/or private in-depth surveys at the country level.

TRENDS IN SURVEILLANCE MECHANISMS: SUMMARY AND CONCLUSION

As is evident from the preceding discussions, surveillance mechanisms differ according to scope, country coverage, variables monitored, type of leverage etc. Tables V.5 and V.6 review the modalities and indicate the coverage of developing countries of the ESCAP region within these global surveillance mechanisms. There are some overlaps in the scope of surveillance by different institutions. BIS seems to have a comparative advantage in setting standards and codes for supervision of the banking system. However, until recently, it dealt almost exclusively with developed markets. Furthermore, it lacks the necessary leverage to elicit policy changes from countries. IMF, on the other hand, has a comparative advantage in exercising surveillance over financial systems and, in collaboration with other agencies, in assessing the compliance with international standards. It has relatively greater leverage in influencing policies but has traditionally concentrated on macroeconomic and exchange rate policies rather than the structural and financial issues which were at the heart of the crisis in Asia. IIF and the credit rating agencies which focus on variables that are closely associated with the financial crisis, such as the level of debt and international capital flows, share the limitations of BIS in respect of policy leverage. These institutions largely depend on market pressure as leverage in influencing needed policy corrections in countries.

How accessible are the findings of the global surveillance institutions? IMF publishes regularly documents on its multilateral activities, including *World Economic Outlook* and *International Capital Markets.* In addition, with the consent of governments of the concerned countries, information on the Fund's bilateral surveillance activities is increasingly being made available to the public through the release of PINs and, in the context of an 18-month pilot project started in the spring of 1999, Article IV consultation reports. However, there is a widespread perception that regional contagion was largely missed by IMF because of its mainly bilateral or global orientation. Most BIS data are available through its web site, but its monitoring-type analyses are confidential to those participating in the meeting. The private monitoring bodies, such as IIF and the credit rating agencies, largely offer their databases and analyses by subscription. Apart from difficulties in accessibility, these mechanisms vary in the nature of their source of database information. Member countries of IMF are required to submit official data on a regular basis. Of course the quality and comparability of the data vary across countries, but SDDS is meant to improve the quality of data reporting. Apart from official sources, BIS and IIF gather more specialized data (banking or capital flows, for example) from their members. Credit rating agencies rely on a multitude of data sources – official, Reuters and other proprietary information – to produce their sovereign risk ratings.

Table V.5. Modalities of global surveillance/monitoring systems

	IMF	*BIS*	*IIF*	*Rating agencies*
Policy surveillance	Bilateral – Article IV Multilateral – *World Economic Outlook* Regional – Euro			Global financial stress *Sovereign credit ratings*
Codes/standards	SDDS GDDS Fiscal transparency Monetary and financial policies	Banking supervision – Core Principles – Capital Adequacy	Risk management for firms investing in emerging markets	
Information/data	Dissemination Standards Bulletin Board Article IV Public Information Notices (PINs) Reports on observance of standards and codes External Debt Statistical publications	External debt Derivatives International banking statistics	Capital flows	
Leverage	Conditionality Article IV	Peer pressure Market pressure	Market pressure	Market pressure
Coverage of developing ESCAP members	Article IV reports from 1998 to Aug. 1999: 33 Report on observance of standards and codes: 1 SDDS: 7		Economic Monthly Review: 12	Standard & Poor's financial stress: 11 Standards & Poor's sovereign ratings: 15 Moody's sovereign ratings: 19

Table V.6. Monitoring of developing countries or areas of the ESCAP region

Countries or areas	*Institute of International Finance*	*International Monetary Fund*				*Joint international financial institutions external debt tables*	*Standard & Poor's*		*Moody's*
	Monthly Economic Review	*Article IV consultation*	*Financial programme*[a]	*Transparency report*	*SDDS*		*Sovereign rating*	*Financial stress*	*Sovereign rating*
South Asia									
Bangladesh		Ö	Ö			Ö			
Bhutan		Ö				Ö			
India	Ö	Ö	Ö		Ö	Ö	Ö	Ö	Ö
Iran (Islamic Republic of)		Ö				Ö			Ö
Pakistan	Ö	Ö	Ö			Ö	Ö		Ö
Sri Lanka		Ö	Ö			Ö			
East and South East Asia									
Brunei Darussalam						Ö			
Cambodia		Ö	Ö			Ö			
China	Ö	Ö				Ö	Ö	Ö	Ö
Democratic People's Republic of Korea						Ö			
Hong Kong, China	Ö	Ö		Ö	Ö	Ö	Ö	Ö	Ö
Indonesia	Ö	Ö	Ö		Ö	Ö	Ö	Ö	Ö
Lao People's Democratic Republic		Ö	Ö			Ö			
Macao, China		Ö				Ö			Ö
Malaysia	Ö	Ö			Ö	Ö	Ö	Ö	Ö
Myanmar		Ö				Ö			
Nepal		Ö	Ö			Ö			
Philippines	Ö	Ö	Ö			Ö	Ö	Ö	Ö
Republic of Korea	Ö	Ö	Ö		Ö	Ö	Ö	Ö	Ö
Singapore	Ö	Ö				Ö	Ö	Ö	Ö
Taiwan Province of China	Ö					Ö	Ö	Ö	Ö
Thailand	Ö	Ö	Ö		Ö	Ö	Ö	Ö	Ö
Viet Nam	Ö	Ö	Ö			Ö			Ö
Central Asia									
Afghanistan						Ö			
Armenia		Ö	Ö			Ö			
Azerbaijan		Ö	Ö			Ö			
Kazakhstan		Ö	Ö			Ö	Ö		Ö
Kyrgyzstan		Ö	Ö			Ö			

Table V.6 *(continued)*

Countries or areas	*Institute of International Finance*	*International Monetary Fund*				*Joint international financial institutions external debt tables*	*Standard & Poor's*		*Moody's*
	Monthly Economic Review	*Article IV consultation*	*Financial programme*[a]	*Transparency report*	*SDDS*		*Sovereign rating*	*Financial stress*	*Sovereign rating*
Mongolia		Ö	Ö			Ö			
Russian Federation		Ö	Ö			Ö	Ö		Ö
Tajikistan		Ö	Ö			Ö			
Turkey		Ö	Ö		Ö	Ö	Ö	Ö	Ö
Turkmenistan		Ö				Ö			Ö
Uzbekistan			Ö			Ö			
Pacific islands									
American Samoa									
Cook Islands							Ö		
Fiji		Ö				Ö			Ö
French Polynesia						Ö			
Guam									
Kiribati		Ö				Ö			
Maldives		Ö				Ö			
Marshall Islands		Ö							
Micronesia (Federated States of)		Ö				Ö			
Nauru						Ö			
New Caledonia						Ö			
Niue									
Northern Mariana Islands									
Palau		Ö							
Papua New Guinea		Ö	Ö			Ö	Ö		Ö
Samoa		Ö				Ö			
Solomon Islands		Ö				Ö			
Tonga		Ö				Ö			
Tuvalu									
Vanuatu		Ö				Ö			

[a] IMF web site *Member's Position in the Fund*, available at <http://www.imf.org/np/tre/tad/exfund1.cfm> (21 February 2000). Financial programmes include those active for any period between 1991 and 2000.

The various surveillance institutions differ according to their ownership structure. IMF is a Bretton Woods institution controlled by a board of official representatives of member countries. The degree of influence in the Fund of a particular member varies, to a large extent, with the amount of the membership contribution to the Fund. The Basle-based committees are more tightly-knit groups composed mainly of the representatives of the central banks of the G-10 countries (BIS is funded by central banks through the purchase of shares). IIF is an association of private financial institutions, while the rating agencies are private companies which are governed by their respective boards (Standard & Poor's is a division of the McGraw-Hill Companies).

A number of initiatives have arisen from the intense soul-searching among global surveillance mechanisms that inevitably followed after the Asian debacle. There appears to be a commonality in the responses of the surveillance mechanisms; many are geared to address or mitigate the perceived causes of the Asian crisis. Perhaps one of the more prominent responses of monitoring mechanisms is to focus on the financial sector and the capital account. This stems from the fact that the vulnerability of the financial system, by and large, escaped the scrutiny of most surveillance systems prior to the collapse of the Thai baht peg in July 1997. The emphasis on the financial sector is also a delayed reaction to the altered world external environment which is marked by deep integration of markets, very massive capital flows and powerful effects of changes in expectations. IMF and the World Bank, for instance, are engaged in the Financial Sector Assessment Programme, which is designed to identify strengths and vulnerabilities of a country's financial system. Standard & Poor's, on the other hand, has come up with financial system stress indicators, on top of its more traditional sovereign credit risk ratings.

Another common thread in the recent initiatives is the emphasis on best practices in disclosure, clarity in policy-making, dissemination of data, accounting practices and even the publication of Article IV staff reports. The set of proposals for the new financial architecture is characterized by a proliferation of standards and codes. One reason for the emphasis on codes and best practices is that in this era of global finance and free flow of capital, there is little choice for countries that wish to tap world capital markets but to adapt their policy-making practices, supervisory systems, levels of information disclosure or accounting methods to world standards.

The stress on transparency is intended to limit the problems of informational asymmetries that seemed to be a significant factor in the Asian crisis, in that the lack of transparency prevented the markets from discerning the increasing fragility of the system. In addition, the availability of good quality data should greatly facilitate the monitoring process.[41] It is increasingly recognized that transparency is critical in the functioning of markets as well as in instilling market discipline.

Obviously the codes or best practices advocated by the existing global mechanisms are a function of the areas of expertise and focus of these institutions. Because the core competency of IMF is in macroeconomic and exchange rate policy, it has proposed standards on transparency in fiscal and monetary policies. Similarly, it has pushed for more comparable and accurate data, which are critical in surveillance work, at the national, regional and multilateral levels, through SDDS or GDDS. BIS, which is more concerned about the stability of banking systems and financial markets, promotes better prudential standards in bank supervision. IIF, on the other hand, is concerned with drawing up risk management standards for firms investing in emerging markets. It is also participating in drawing up best practices in transparency in concert with the other international financial institutions. IOSCO, IAIS and IASC are developing or revising standards in their respective areas. By working together, the nexus of agencies, both public and private, seem able to cover the gamut of issues where standards or codes are required at the present time. However, there is still a risk that some areas which can create global stress and shocks may be omitted unless vigilance is exercised in monitoring and in research and analysis and adequate coordination is achieved.

[41] In general, it is easy to understand that financial systems can adjust more readily to gradual changes in premiums, capital flows etc. More destabilizing to systems are shocks such as abrupt and massive changes in prices or flows. As the saying goes, it is not speed that kills, but the sudden stop. If there are high levels of transparency in the system, points of vulnerability can be picked up earlier, before massive corrections occur.

To enhance the effectiveness of the codes and standards, it would appear that the following issues need to be addressed. At present, most of them are optional and not binding, even for the members of the organization devising the instrument. Hence, unless adequate incentives are created to encourage implementation, there is no assurance that countries will adhere to these codes or standards. Proper monitoring mechanisms should go beyond simply monitoring formal compliance with the standards. Rather, the methodology with which the data are collected and analysed, the degree of compliance and problem areas should be subject to monitoring as well. Given that financial markets are dynamic and not static, the types of data reported may also change through time. Hence, there is a need for international organizations to evaluate the appropriateness and relevancy of the existing reporting requirements constantly. Finally, it should be borne in mind that reporting and monitoring compliance of certain international benchmarks is not a panacea for crisis prevention.

Recent initiatives are marked by a greater reliance on market forces. Prior to the crisis, unless a country was subject to IMF conditionalities, there appeared to be little incentive to disclose information, especially by emerging markets. With the new, very public initiatives in the area of transparency, countries and firms alike are under greater pressure to disclose information for fear of being accused of having something to hide. When there are codes and standards, market participants will, in time, expect banks or countries to observe them. The markets can thus reward or punish firms or countries, by, say, applying a risk premium, based on their record of compliance.

There seems to be more cooperation among surveillance mechanisms in the aftermath of the Asian crisis. For instance, BIS, IMF, OECD and the World Bank have collaborated in setting up statistics on external debt. IMF and the World Bank likewise have participated with BIS in drafting a handbook on the methodology for assessing implementation of the Core Principles and in identifying areas in which further work could help countries achieve compliance. There is also a clearer distinction between the areas of competence as indicated by the codes and standards advocated by particular institutions. In time, because of the harmonization of international standards, it is likely that the problems of differences in the definition of data or indicators among different surveillance bodies will be resolved.

The Financial Stability Forum is a prime example of a cooperative arrangement among major global surveillance bodies, national authorities and other regulatory agencies. It is a consultative body consisting of representatives of the finance ministries and central banks of the G-7 countries, IMF, the World Bank, BIS, IOSCO, OECD and other agencies. This arrangement appears to be motivated by the need for a more coordinated response to the problems posed by the global financial system. The objectives of the Forum include pooling and sharing information on vulnerabilities in the international financial system among different bodies, and some kind of monitoring of the implementation of internationally agreed regulatory and supervisory standards and codes of conduct.[42]

The Forum serves as a vehicle for identifying regulatory gaps and areas of vulnerability in the international financial system. It could become a significant force for effective policy responses, especially where coordination is necessary. However, it is not a representative body because emerging markets are not included. It is clear that the inclusion of the systemically important countries is crucial if the Forum is to achieve the minimum degree of representation and participation that is needed.[43] The Forum has a small secretariat in Basle and is chaired by the General Manager of BIS.

Lastly, there is greater interest in the area of managing the risk of globalization of financial markets. The Core Principles are focused primarily on risk management in banks. Financial stress testing exercises are being contemplated in the Financial Stability Forum where possible changes in liquidity conditions or exchange rate changes, for instance, are posited and the consequences are examined. Indeed, given that the costs of crises are so huge in a globalized setting, surveillance mechanisms are increasingly investing in risk management and prudential norms.

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[42] Yilmaz Akyüz and Andrew Cornford, "Capital flows to developing countries and the reform of the international financial system", paper presented for the World Institute for Development Economics Research (WIDER), project on New roles and functions for the UN and the Bretton Woods institutions (Geneva, UNCTAD, 1999).

[43] Montek S. Ahluwalia, "Key issues in reforming the global financial architecture", paper submitted to the Commonwealth Finance Ministers Meeting, Cayman Islands, 21-23 September, 1999.

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Annex V.2.

INTERNATIONAL CODES AND STANDARDS FOR FINANCIAL MARKETS

Codes and standards of best practice arose out of the need to overcome informational asymmetry, help improve the functioning of markets and aid in monitoring performance. Their provision has in fact become an important element in the current debate on the new financial architecture. Since the advent of the Asian crisis, a number of international organizations and other bodies have either revised existing codes or standards or developed new ones for certain segments of the financial markets.

These codes and standards are expected to (i) give clarity to the roles and responsibilities of each participant in the market; (ii) increase the availability of information and reduce uncertainty, which fosters herd-like behaviour on the part of investors; (iii) increase the transparency and accountability of financial institutions as well as the governments; (iv) facilitate monitoring by improving the extent of comparability of performance across markets; and (v) establish international benchmarks or norms in various fields. It is strongly believed that the adoption of internationally recognized standards and codes of good practices can help improve economic policy-making and strengthen the international financial system.

Initiatives for developing codes and standards have been undertaken by different international organizations and agencies according to their focus or specialization. Adherence to these codes and standards is not compulsory, but based on a voluntary approach. Nevertheless, institutions like IMF and the World Bank encourage developing countries to comply with the standards proposed by themselves and other standard-setting bodies such as the Basle Committee, and offer technical assistance in implementing the codes. However, since many of the codes (for example, the Capital Accord) were developed for the situation in developed countries, there is the risk that the standards may not be equally relevant to the situation in the developing and least developed countries.

The following provides a brief overview of the features of the more important standards and codes of best practices relevant to financial markets.

Accounting. The International Accounting Standards Committee is an independent private sector body formed in 1973 with members from 142 professional accountancy organizations in 101 countries. The objective of IASC is to formulate and publish accounting standards for the private sector. It also aims to work towards improving and harmonizing the different sets of regulations, procedures and accounting standards related to the reporting of the financial statements. It intends to achieve uniformity in the accounting principles used by the private sector for financial reporting across the world. Since 1974, IASC has published and updated series of 39 International Accounting Standards addressing specific topics such as the presentation of financial statements, business combinations, and financial instruments: recognition and measurement.[a]

To illustrate its thrust to instil a harmonized reporting format, IASC suggests the following framework for the preparation and presentation of financial statements: (i) objective of the statement; (ii) underlying assumptions; (iii) qualitative characteristics of financial statements, such as relevance, reliability, and constraints on relevant and reliable information; (iv) elements of financial statements – asset, liability, equity, and income and expenditure; and (v) concepts of capital and capital maintenance. The set of core accounting standards is designed in such a way that private corporations could use them for cross-border offerings and listings in all global financial markets.

The International Federation of Accountants is formulating accounting standards which are based on the International Accounting Standards for the public sector. Work is expected to be completed by 2001.

IASC does not impose the use of its standards on its members – the adoption of standards remains the decision of national authorities, or self-regulatory organizations or enterprises. In some cases, stock exchanges require foreign issuers to present financial statements in accordance with the International Accounting Standards format as a precondition for listing on the exchange.

IMF has established contacts with IASC and IFAC. While accounting and auditing standards are not one of the core competencies of IMF, these standards are important for certain areas of its work. The adoption of international accounting standards in a country has become an element of recent stabilization programmes of IMF.

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[a] The list of published and updated series of the 39 IAS standards is available at <http://www.iasc.org.uk/frame/cen2_1.htm> (14 January 2000).

Auditing. The International Auditing Practices Committee is a committee of IFAC and its membership consists predominantly of national accountancy organizations. The objective of IAPC is to improve the degree of uniformity of auditing practices and related services throughout the world.

The majority of IFAC members use the IAPC International Standards on Auditing as a basis for developing their own national standards. However, these standards have no legal force. Members are simply expected to use their best efforts to see that IFAC and IASC principles and standards are applied in their domestic auditing systems.

The World Bank has supported both IASC and IFAC in developing harmonized accounting and auditing standards and, in fact, has provided funding from its Development Grant Facility to accelerate standard-setting in both bodies. It also participates as an observer in several committees and disseminates the auditing standards for use in the reporting of Bank-assisted project activities.

Banking supervision. The work on developing principles to promote prudential norms in banking is relatively advanced. The Committee on Banking Supervision was established at the end of 1974 in the wake of the failure of Bankhaus Herstatt in Germany. The first task of the Committee was to consider methods of improving early warning systems for banking crises. Subsequently, the Committee explored international cooperation for improving the quality of banking supervision worldwide, mainly by way of improving the exchange of information on national supervisory arrangements and enhancing the techniques for supervising international banking businesses and by setting minimum standards in areas where they are considered desirable. Among the significant outputs of the Committee are the Basle Capital Accord and the Basle Core Principles for Effective Banking Supervision.[b]

The Basle Committee on Banking Supervision promulgated the Basle Capital Accord in July 1988, to ensure that internationally active banks maintain a level of capital commensurate with the risks they bear. The Accord laid down minimum capital adequacy requirements (8 per cent ratio of capital to weighted risk assets) based on relative levels of exposure to various forms of credit risk, both on and off balance sheet. By September 1993, all banks in G-10 countries with significant international operations were meeting or exceeding the minimum requirements.

Given the growing extensive dealings between corporate customers from two or more countries, the concept of country risk is expanding well beyond its traditional scope, which primarily encompassed only sovereign risk and transfer risk.[c] The expansion of G-10 creditor claims against foreign commercial entities has forced banks to broaden their concept of credit risk management to incorporate the potential default of foreign private sector non-bank enterprises arising from country-specific economic factors. The Asian crisis, as well as other recent developments, has resulted in banks separately identifying individual foreign enterprises that are more exposed to local country conditions than others.

In response to the deterioration in the capital ratios of main international banks, as well as the growing risks of heavily indebted countries, the Basle Committee had resolved to increase the overall amount of capital in the banking system and work towards greater convergence in the measurement of capital adequacy. The Basle Accord is currently under review. A proposed new framework was issued in 1999 in the form of a consultation paper. Comments on this are to be made before March 2000. Its major features are as follows: (i) minimum capital requirements which seek to enhance the standardized rules in the 1988 Basle Accord; (ii) supervisory review of an institution's capital adequacy and internal assessment process; and (iii) market discipline as a lever to strengthen disclosure and encourage safe and sound banking practice.[d]

The Board of the Basle Committee on Banking Supervision issued the Core Principles for Effective

[b] For more details, see *BIS International Convergence of Capital Measurement and Capital Standards* (July 1988), available at <http://www.bis.org/publ/bcbs04a.htm> (18 January 2000) and *BIS Core Principles for Effective Banking Supervision (Basle Core Principles),* available at <http://www.bis.org/publ/bcbsc102.pdf> (18 January 2000).

[c] This refers to the ability or willingness of a sovereign government to honour its cross-border debts and to make available foreign exchange so that otherwise viable local debtors could meet foreign-denominated cross-border claims.

[d] The press release containing the main elements of the proposed framework is available at <http://www.bis.org/press/p990603.htm> (20 January 2000).

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Banking Supervision[e] in 1997 in order to strengthen the supervisory systems of national financial markets. As minimum standards, the Core Principles comprise 25 basic principles that are considered essential for any supervisory systems to be effective. Broadly, these principles cover the following areas: pre-conditions for effective banking supervision; licensing and structure; prudential regulations and requirements; methods of ongoing banking supervision; information requirements; formal powers of supervisors; and cross-border banking. These principles reflect a significant development in at least four respects: (i) they are comprehensive and cover all aspects of banking; (ii) they provide a checklist of good practices for use by supervisors, international financial institutions, rating agencies and other market participants; (iii) they were drawn up with the active participation of non-G-10 supervisory authorities; and (iv) they apply to G-10 and non-G-10 countries alike.

The Basle Committee is continuing to develop standards in key risk areas such as credit risk management and disclosure. IMF and the World Bank use the Core Principles document to assist individual countries in strengthening their supervisory arrangements with the objective of promoting macroeconomic and financial stability. This document constitutes the main background material for the training offered at the Toronto Centre for Financial Sector Supervision set up by BIS, the Government of Canada and the World Bank.

Bankruptcy. Restructuring a financial system requires a system in which the assets of a failed entity can be priced and sold in a market in an efficient manner. In this way, resources that would otherwise have remained unused could be injected back into the real sector and converted into productive investment. Crisis resolution hinges, in no small measure, on the timely and efficient disposal of assets. However, the experience of the Asian crisis has shown that the process can be hindered by inadequacies in bankruptcy procedures and legislative guidelines. While the bulk of the institutional reforms pertaining to bankruptcy have to be implemented domestically, there have been a number of initiatives in addressing cross-border bankruptcy and insolvency issues.

Domestic bankruptcy systems vary considerably across countries, reflecting not only disparate legal traditions and practices but also different social and political choices. Given these differences, regional and multilateral initiatives to harmonize domestic bankruptcy laws have made little progress. More success has been achieved in promoting the harmonization of treatment for cross-border bankruptcy problems. It should be noted that initiatives in this area do not attempt to harmonize domestic bankruptcy laws.

To illustrate, the European Union adopted the Convention on Insolvency Proceedings in 1995. This Convention sets the rules for the treatment of insolvencies where the debtor has establishments and assets in more than one EU member State. It would provide, *inter alia*, for the international distribution of jurisdiction, choice of law, cooperation between the courts of different EU member States, and recognition of foreign judicial decisions and orders. However, the Convention has not yet been ratified by all member States and the prospects for its entering into force are still in doubt.

The United Nations Commission on International Trade Law developed a Model Law on Cross-border Insolvency which was adopted by UNCITRAL members in May 1997. This law has the following objectives: (i) cooperation between the courts and competent authorities of States involved in cases of cross-border insolvency; (ii) greater legal certainty for trade and investment; (iii) fair and efficient administration of cross-border insolvencies that protects the interest of all creditors and other interested persons; (iv) protection and maximization of the value of the debtor's assets; and (v) facilitation of the rescue of financially troubled businesses. Furthermore, the model law is designed to provide greater predictability regarding the extent to which, for example, creditor action will be recognized by a local court. It also provides for the non-discrimination of foreign creditors. Adoption of the model law is under consideration in a number of countries.

Corporate governance. Corporate governance refers to the set of principles, rules and practices that define the agency relationship between the stakeholders (shareholders, lenders and, in some countries, employees) in a corporation and the persons entrusted with its management. By definition, corporate governance aims to ensure a proper discharge by managers of their duties to the corporation's constituents. In this respect, managers have the fiduciary duty to maximize the value that shareholders derive from their investment in the corporation, while at the same time respecting the rights of other stakeholders.

The fragility of the financial system in a number of affected economies can be traced partly to the overly risky positions taken by many interconnected firms.

[e] Together with the Core Principles, the Committee released a compendium of existing Basle Committee recommendations, guidelines and standards, and has continued to update the compendium.

Private lenders in recent years have been underpricing risk. Competition in the financial area has increased markedly and, as profits have been harder to come by, pressure to maintain or even expand profit levels may have induced some financial institutions to engage in riskier endeavours.[f]

In response to a request made at its 1998 Ministerial Meeting, OECD has established a task force to develop international guidelines to improve corporate governance practices among its member countries. It is also envisioned to serve as a reference point for non-member countries. With respect to financial institutions in particular, the OECD work on institutional investors stressed the need for developing a common understanding on risk management standards and risk accounting standards. The task force is led by the OECD Directorate of Financial, Fiscal and Enterprise Affairs, and includes members from securities regulatory agencies, stock exchanges, the private sector and relevant international organizations, including IMF and the World Bank.

The OECD Business Sector Advisory Group on Corporate Governance issued a report in April 1998 entitled "Corporate governance: improving competitiveness and access to capital in global markets",[g] which seeks to identify principles of sound corporate governance. The report rejected the one-size-fits-all approach to corporate governance, but recognized the need for an international reference point and identified some fundamental parameters as a basis for initiatives to improve governance. These parameters include the following points: (i) increased acceptance of maximizing shareholder value as the primary corporate objective; (ii) acceptance of increased transparency and independent oversight of management by boards of directors; (iii) making a board's practice subject to voluntary adoption and evolution, taking into account global minimum standards; and (iv) the adoption of universal rules in certain areas (such as accounting) is preferable.

[f] See the discussion in William R. White, "New strategies for dealing with the instability of financial markets", paper presented at the Conference on the Management of Global Financial Markets: Challenges and Policy Options for Emerging Economies, the EU and the International Institutions, Forum on Debt and Development at the National Bank of Hungary, Budapest, 24-25 June 1999.

[g] A summary of this report is available at <http://electrade.gfi.fr/cgi-bin/OECDBookShop.storefromt/1329864493/Search/Run> (20 January 2000).

Apart from OECD, other international and regional institutions are promoting better corporate governance in various ways. For example, the World Bank supports reform of corporate governance in developing countries, and has undertaken corporate governance assessments in eight countries in cooperation with APEC. EBRD has also been active in developing sound business standards and corporate practices; EBRD borrowers and co-investors are expected to commit themselves to adhering to these standards and practices.

Finally, the Basle Committee also addresses corporate governance in the context of banking supervision. It issued a paper in September 1999 entitled *Enhancing Corporate Governance in Banking Organizations,* which provides guidance on corporate governance in banks, based on supervisory experience in banking organizations on governance problems, and suggests the types of practices that would help avoid such problems.

Data dissemination. The Special Data Dissemination Standard and the General Data Dissemination System were established by IMF in 1996 and 1997 respectively; they are intended to enhance the quality and integrity as well as the availability of timely and comprehensive economic and financial statistics, which in turn is expected to contribute to the pursuit of sound macroeconomic policies.

GDDS is meant to be a step towards subscription to SDDS for those countries which do not yet have sophisticated statistical systems. Participation in GDDS is voluntary. The implementation of GDDS is expected to be carried out in two phases over the next six to seven years. The first phase will focus on the education and training of member countries. In the second phase, IMF staff will work directly with member countries to assist them in assessing their current practices and developing plans for improvements.

SDDS is a best-practice standard against which a country's dissemination practices can be readily measured. Although subscription is voluntary, it entails a commitment by a subscribing member to observe the standard and provide information to IMF about its practices in disseminating economic and financial data. At present, 47 countries have subscribed to SDDS. It covers four sectors of the economy, real, fiscal, financial and external, and has four dimensions: the coverage, periodicity and timeliness of the data; access by the public to those data; the integrity of the data; and the quality of the data. For each of these dimensions, SDDS prescribes two to four monitorable elements: good practices that can be observed or monitored by the users of statistics, as reported in the table below.

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Summary of the Special Data Dissemination Standard

1. The data: coverage, periodicity, and timeliness Comprehensive economic and financial data, disseminated on a timely basis, are essential to the transparency of macroeconomic performance and policy.	**Measure:** The dissemination of economic and financial data categories has to follow the prescriptions of IMF, with the components, periodicity and timeliness as indicated.
2. Access by the public Dissemination of official statistics is an essential feature of statistics as a public good. Ready and equal access is a principal requirement for the public, including market participants.	**Measures:** (a) Advance dissemination of release calendars. (b) Simultaneous release to all interested parties.
3. Integrity To fulfill the purpose of providing the public with information, official statistics must have the confidence of their users. In turn, confidence in the statistics ultimately becomes a matter of confidence in the objectivity and professionalism of the agency producing the statistics. Transparency of its practices and procedures is a key factor in creating this confidence.	**Measures:** (a) Dissemination of the terms and conditions under which official statistics are produced, including those relating to the confidentiality of individually identifiable information. (b) Identification of internal government access to data before release. (c) Identification of ministerial commentary on the occasion of statistical releases. (d) Provision of information about revision and advance notice of major changes in methodology.
4. Quality A set of standards that deals with the coverage, periodicity and timeliness of data must also address the quality of statistics. Although quality is difficult to judge, monitorable proxies, designed to focus on information which the user needs to judge quality, can be useful.	**Measures:** (a) Dissemination of documentation on methodology and sources used in preparing statistics. (b) Dissemination of component detail, reconciliation with related data, and statistical frameworks that support statistical cross-checks and provide assurance of reasonableness.

Source: IMF, Special data dissemination standards, *Dissemination Standards Bulletin Board,* available at <http://dsbb.imf.org/overview.htm> (20 January 2000).

Under SDDS, IMF is prescribing dissemination standards for 17 data categories covering the real, financial, fiscal and external sectors of the economy, as shown below:

Categories and components of data under the SDDS

Categories	*Components*
Real sector	
1. National accounts: nominal, real, and associated prices	GDP by major expenditure category and/or by productive sector
2. Production indices	Industrial, primary commodity, or sector, as relevant
3. Labour market	Employment, unemployment, and wages/earnings, as relevant
4. Price indices	Consumer prices and producer or wholesale prices

Categories	Components
Fiscal sector	
5. General government or public sector operations, as relevant	Revenue, expenditure, balance and domestic (bank and non-bank) and foreign financing
6. Central government operations	Budgetary accounts; revenue, expenditure, balance and domestic (bank and non-bank) foreign financing
7. Central government debt	Domestic and foreign, as relevant, with a breakdown by currency, as relevant, and a breakdown by maturity; debt guaranteed by central government, as relevant
Financial sector	
8. Analytical accounts of the banking sector	Money aggregates, domestic credit by public and private sector, external position
9. Analytical accounts of the central bank	Reserve money, domestic claims on public and private sector, external position
10. Interest rates	Short-term and long-term government security rates, policy variable rate
11. Stock market	Share price index, as relevant
External sector	
12. Balance of payments	Goods and services, net income flows, net current transfers, selected capital account items (including reserves)
13. International reserves	Gross official reserves (gold, foreign exchange, SDRs and fund position) denominated in US dollars
14. Merchandise trade	Exports and imports
15. International investment position	
16. Exchange rates	Spot rates and three- and six-month forward market rates, as relevant
17. Population	

Source: IMF, *SDDS Data Categories,* available at <http://dsbb.imf.org/category.htm> (20 January 2000).

The formal period for the implementation of the database system by the SDDS subscribers began in early 1996 and ended on December 1998. During that period, a member could subscribe to SDDS even if its dissemination practices were not fully in line with SDDS. A specified time was given for subscribers to adjust their practices according to the requirements.

A subscriber is expected to submit information about its data and dissemination practices (called metadata) to IMF for presentation on an electronic bulletin board maintained by the IMF Dissemination Standards Bulletin Board. The Board now provides hyperlinks between the SDDS metadata and actual country data, shown in a national summary data page, for 18 countries. It should be noted that the subscriber alone is responsible for the accuracy of the metadata and the actual economic and financial data.

IMF is encouraging SDDS subscribers to collect and release data on forward-looking indicators (for example, business surveys, orders), debt-service projections, FDI, and portfolio investment. The IMF Executive Board undertook a second review of experience with SDDS in December 1998. The review considered an extension of the data coverage of SDDS on international reserves and external debt.[h] SDDS subscribers are obliged to provide information on the composition of reserve assets, other foreign assets held by the central bank and government, short-term foreign liabilities, and

[h] The effort to improve data dissemination of international reserves and external debt underpins the Fund's increased focus on vulnerability assessment. Countries have begun enhanced disclosure of international reserves data based on the format of the SDDS International Reserves Template approved by the Executive Board on 23 March 1999. The countries which disseminate information on the foregoing data are Canada, France, Germany, the Netherlands, Switzerland and the United Kingdom.

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related activities that can lead to a drain of reserves (such as financial derivatives and government guarantees for private borrowing). Procedures for the monitoring of the observance of the standards were also established, as well as penalties such as removal from the Dissemination Standards Bulletin Board upon non-observance. However, to this date only six subscribers are reporting these data; none of them is a developing ESCAP member.

The Executive Board also agreed that the SDDS prescription should be for dissemination of full data corresponding to the new template on a monthly basis, with a lag of no more than one month, although data on total reserve assets would still be prescribed for dissemination on a monthly basis with a lag of no more than one week. The dissemination of data for the full template on a weekly basis, with a one-week lag, was to be encouraged. The new standards were started formally in August 1999, with Canada, France, Germany, Switzerland and the United Kingdom as the only participating members. The transition period for the observance of the new standards is through 31 March 2000, when all SDDS subscribers are required to disseminate data in line with the new SDDS template.

Fiscal transparency. In April 1998, the Interim Committee of IMF adopted the Code of Good Practices on Fiscal Transparency[i] to guide members seeking to increase fiscal transparency, and thereby to enhance the accountability and credibility of fiscal policy as a key component of good governance. The rationale for the Code is that providing better information to the public will make governments more accountable, and thereby strengthen fiscal policy credibility.

This Code rests on four principles. First, a government should clearly define its roles, responsibilities and activities which have an impact on the rest of the economy. This should be done within a clear legal and administrative framework. Second, it should make a commitment to provide comprehensive and reliable information, which includes its past, present and projected fiscal activity. Third, the process of budget preparation should be clear and should also include well-presented budget estimates that facilitate policy analysis and allow for international comparison, with clearly defined procedures of execution and monitoring. Lastly, the integrity of fiscal information should be capable of being counterchecked by a national auditing body.

Countries are encouraged to implement the code on a voluntary basis and no formal subscription process is currently envisaged. A manual on implementation of fiscal transparency has been prepared and approved by the Executive Board. The manual sets out the principles and practices in more detail, drawing on existing international standards and experiences of member countries to illustrate good practices.

Through technical assistance missions and other contacts with country authorities, IMF staff members have initiated discussion on fiscal transparency and have begun to direct technical assistance resources to help countries seeking to improve fiscal transparency. Efforts to encourage implementation of the Code have begun by focusing on a small group of countries in which a lack of fiscal transparency affects policy formulation and implementation directly. Work has also started on a pilot basis to undertake country-level assessments of fiscal policy.[j]

Insurance regulations. The International Association of Insurance Supervisors is responsible for developing internationally accepted principles and standards on insurance supervision and training insurance supervisors from emerging market economies.[k] Recommendations or principles produced by IAIS are meant to be advisory rather than binding for its members. In September 1997, IAIS issued two sets of standards: (i) insurance supervisory principles, addressing general issues such as licensing, ownership, change in shareholders control, off-site analysis, on-site examinations, information disclosure and supervisory powers; and (ii) principles applicable to the supervision of international insurers and insurance groups and their cross-border establishments, on-site and off-site supervision of cross-border entities, information and audit. Three additional standards were adopted in October 1998 relating to licensing, on-site inspection and supervision of derivatives. Future standards will cover solvency requirements and reinsurance. Progress in harmonizing solvency requirements will depend on having a uniform accounting standard in place. There is no uniform international standard of accounting for insurance companies, although IASC has begun a project aimed at achieving such a uniform standard by 2002.

In February 1999, the Executive committee of IAIS decided to establish a task force to elaborate a methodology of how best to assess the implementation of the IAIS principles and standards in the different jurisdictions. In addition, IAIS is responsible for training

[i] IMF, *Code of Good Practices on Fiscal Transparency – Declaration on Principles,* available at <http://www.imf.org/external/np/fad/trans/code.htm> (20 January 2000).

[j] IMF, *Experimental Case Studies on Transparency Practices* (Washington DC, April 1999), available at <http://www.imf.int/external/np/exr/facts/transpar.htm> (20 January 2000).

[k] Detailed information on IAIS can be obtained at <http://www.iaisweb.org/1/index.html> (20 January 2000).

insurance supervisors from emerging economies. It has developed a self-assessment programme for its members and has solicited assistance from the World Bank in distributing the principles, standards and guidance notes to insurance supervisors.

Monetary and financial policies. The Interim Committee called on IMF to develop a code of transparency practices for monetary and financial policies, in cooperation with appropriate institutions. As a result, IMF, along with BIS, the World Bank, OECD etc., prepared a Code of Good Practices on Transparency in Monetary and Financial Policies which was adopted by the IMF Interim Committee in September 1999.[l] The Code identifies practices that would enhance the transparency of central banks in their conduct of monetary policy as well as other financial policies. The transparency practices listed are designed to meet the following objectives: (i) clarity of the roles, responsibilities and objectives of central banks and financial agencies; (ii) open process of formulating and reporting of monetary policy decisions by the central bank and of financial policies by financial agencies; (iii) public availability of information on monetary and financial policies, on the grounds that monetary and financial policies can be made more effective if the public knows the goals and instruments of policy and if the authorities make a credible commitment to meeting them; and (iv) accountability and assurances of integrity by the central banks and financial agencies. Good governance calls for central banks and financial agencies to be accountable, particularly in areas where monetary and financial authorities are granted a high degree of autonomy. A compendium of good practices and other material to provide guidance on the implementation of the Code is being prepared.

Securities market regulation. Regulation of national securities and futures markets is conducted through both government regulators and self-regulatory organizations, which include securities and futures exchanges. The International Organization of Securities Commissions[m] is working to establish universal principles for securities regulation, which could be adopted by official regulators. Thirty principles of securities regulators have been set out, based on three objectives: to protect investors; to ensure that markets are fair, efficient and transparent; and to reduce systemic risk. The principles are divided into eight categories: the responsibilities of the regulator; self-regulation; enforcement of securities regulation; cooperation in regulation; issuers; collective investment schemes; market intermediaries; and the secondary market. The document also provides securities regulators with a yardstick against which progress towards effective regulation can be measured. IOSCO has an extensive committee structure and produces recommendations that are meant to be advisory, rather than binding, on the membership.

IOSCO has also released a number of documents that spell out standards for various specific aspects of security trading. For instance, in March 1998, it released a consultative document entitled *Risk Management and Control Guidance for Securities Firms and their Supervisors.* The paper provides a benchmark by which both securities firms and their supervisors may assess risk management and control systems. A report, *Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms Which Permit the Use of Models under Prescribed Conditions* was released in May 1998 advising supervisors that it was acceptable, subject to suitable safeguards, to incorporate the output of value-at-risk models in the calculation of regulatory capital for market risk for internationally active securities firms.

IOSCO and the Basle Committee have been issuing the annual survey on the *Trading and Derivatives Disclosures of Major G-10 Banks and Securities Firms* since November 1998. They also issued a joint paper in October 1999 outlining the revised recommendations on trading and derivatives disclosure. The IOSCO Technical Committee has collaborated with IASC to evaluate the proposed international accounting standards. This evaluation is focused on whether the Committee should recommend endorsement of the IASC core standards to its members for use by foreign issuers in cross-border listings and offerings.

Others. The BIS-based Committee on Payment and Settlement Systems is working towards improvements in the robustness of payments systems in three areas: the implementation of real time settlement payment systems; a shift to delivery versus payment settlement systems in securities markets; and the elimination of settlement lags in foreign exchange markets through the creation of a specialized bank. The BIS-based Committee on the Global Financial System is working to identify practices and structures that support deep and liquid forward markets. IMF has been working closely with the Committee on a disclosure template that would be consistent with the strengthening of the SDDS data category for reserves.

IIF has organized a series of working groups to identify best practices and develop standards in a number of areas. These include data standards for emerging market economies; best practices for financial firms to manage risk exposure to emerging market economies; common financial industry definition for non-performing loans; and criteria for loan classification.

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[l] IMF, *Code of Good Practices on Transparency in Monetary and Financial Policies,* available at <http://www.imf.org/external/np/mae/mft/index.htm> (20 January 2000).

[m] Information on the work of IOSCO is available at <http://www.iosco.org/iosco.html> (20 January 2000).