The Road to International Financial Stability:

Ar Key Financial Standards the Answer?

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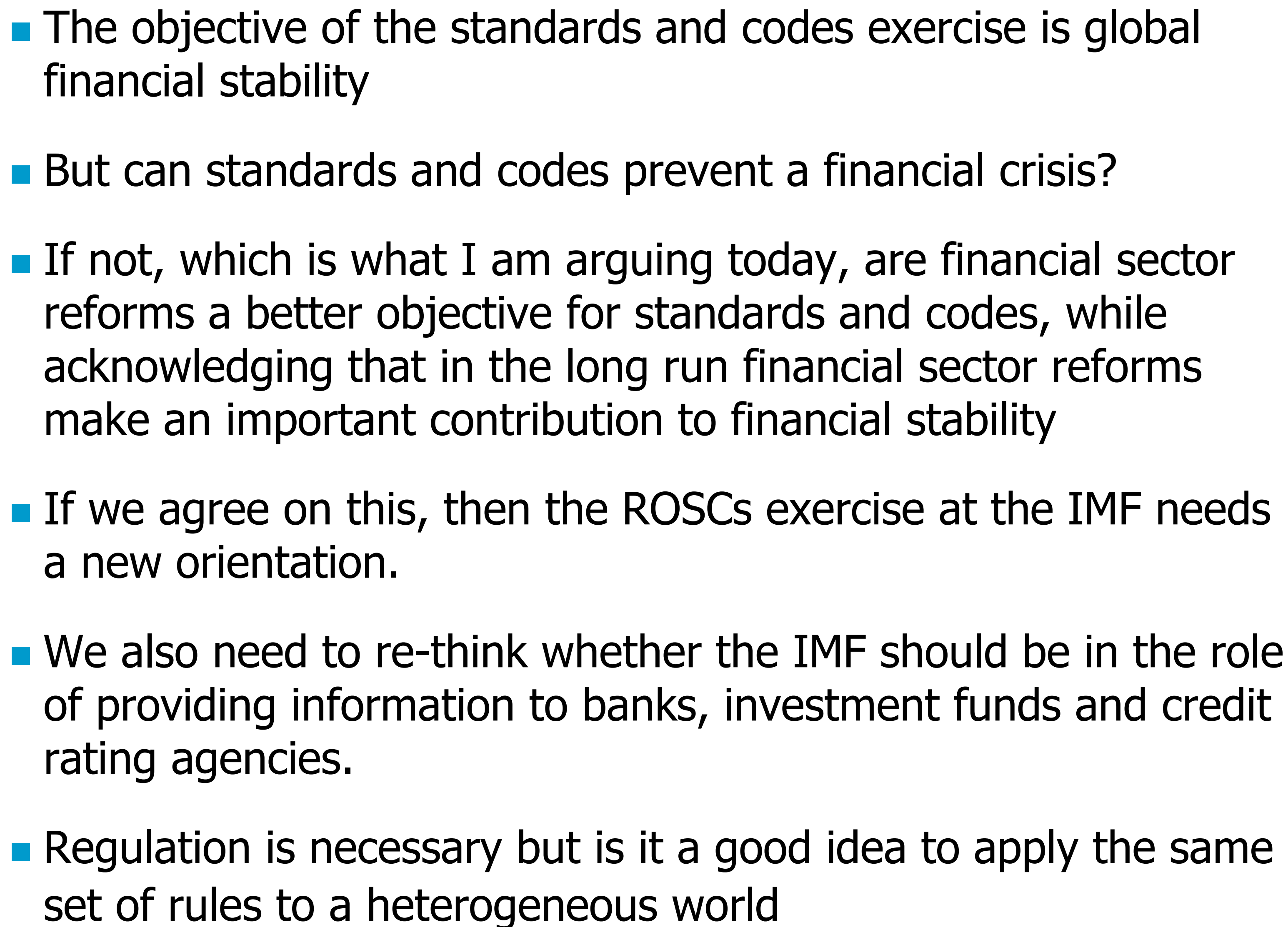

The objective of the standards and codes exercise is global financial stability
But can standards and codes prevent a financial crisis?
If not, which is what I am arguing today, are financial sector reforms a better objective for standards and codes, while acknowledging that in the long run financial sector reforms make an important contribution to financial stability
If we agree on this, then the ROSCs exercise at the IMF needs a new orientation.
We also need to re-think whether the IMF should be in the role of providing information to banks, investment funds and credit rating agencies.
Regulation is necessary but is it a good idea to apply the same set of rules to a heterogeneous world

Table 1: Key Standards for Financial Systems

Subject Area	Key Standard	Issuing Body
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial policies	IMF
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard (SDDS)	IMF
Institutional and market infrastructure		
Insolvency	Principles and Guidelines on Effective Insolvency System	World Bank
Corporate Governance	Principles of Corporate Governance	OECD
Accounting and Auditing	International Financial Reporting Standard	International Accounting Standards Committee (IASC)
Payment and settlement	Core Principles for Systematically Important Payment Systems	Committee on Payment and Settlement Systems (CPSS)
Money Laundering	The Forty Recommendations	Financial Action Task Force (FATF)
Financial regulation and supervision		
Banking Supervision	Core Principles for Effective Banking Supervision	Basle Committee on Banking Supervision (BCBS)
Securities Regulation	Objectives and Principles of Securities Regulation	International Organisation of Securities Commissions (IOSCO)
Insurance Supervision	Insurance Supervisory Principles	International Association of Insurance (IAIS)

Source: Financial Stability Forum

Three sources of information on compliance with Standards and Codes

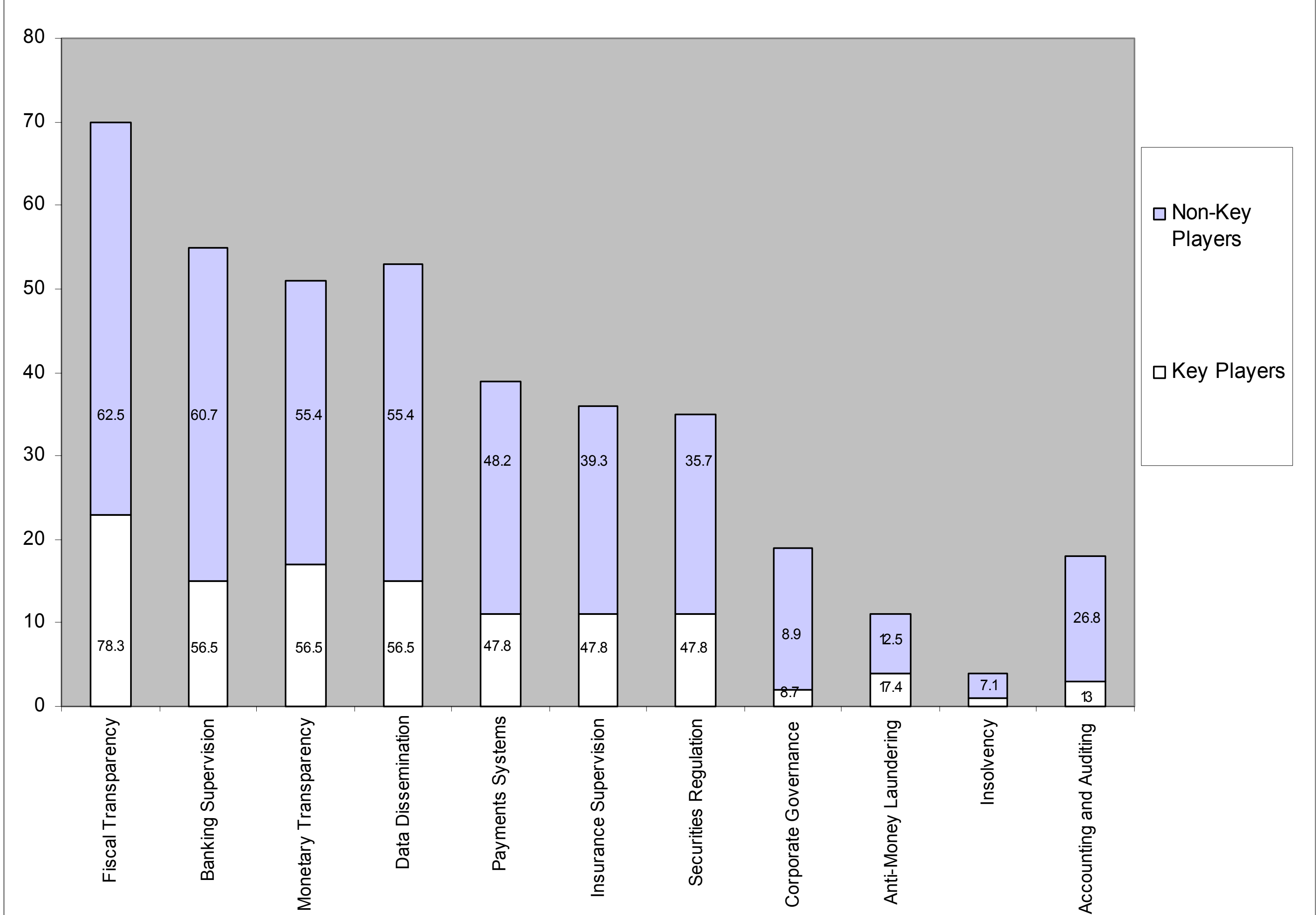
- Reports on Observance of Standards and Codes, IMF
- Self-Assessment by Countries
- Private sector initiative
  - e-Standards Forum
  - Credit Lyonnais - 20 countries fiscal transparency standard
  - Standards and Poor - assessment of corporate governance standard
  - Price-Water House - opacity index

Distribution of ROSCs published by region and category
(as of May 2004)

	Africa	Asia	Western Hemisphere	Middle East	Transition	Advanced	Total
ROSCs published							
Data Dissemination	13	4	7	4	17	8	**53**
Fiscal Transparency	13	8	9	4	22	14	**70**
Monetary Transparency	8	2	3	5	17	16	**51**
Banking Supervision	13	2	3	4	20	13	**55**
Securities Regulation	4	2	2	3	13	11	**35**
Insurance Regulation	6	3	2	2	13	10	**36**
Payments Systems	4	2	2	5	15	11	**39**
Corporate Governance	3	4	1	3	8	0	**19**
Accounting and Auditing	2	1	0	0	4	0	**7**
Insolvency	0	0	1	0	3	0	**4**
AMT/CTF	2	2	2	0	3	2	**11**
Total	**68**	**30**	**32**	**30**	**135**	**85**	**380**

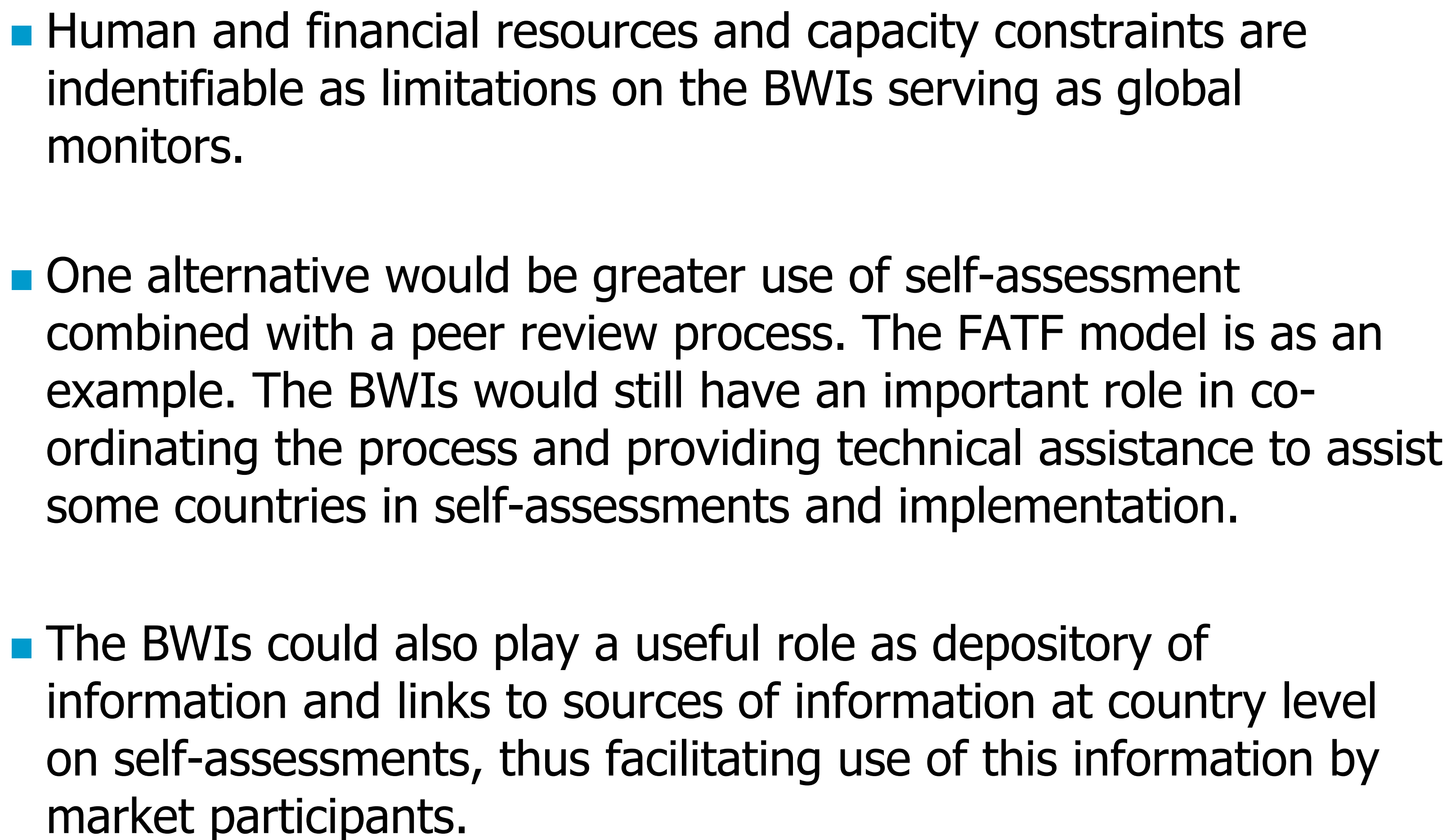
Number of ROSCs Published by Key and Non-Key Financial Players*

(Figures in bars indicate proportions within categories)



*23 key players: G-10 (Canada, France, Germany, Italy, Japan, Sweden, Switzerland, UK, USA) and major EMEs (Argentina, Brazil, Hong Kong SAR, India, South Korea, Mexico, Philippines, Poland, Russia, Singapore, South Africa, Turkey); 53 non-key.

- 380 ROSCS from 79 countries published from a membership of 184 countries.
- ROSCs for majority of the OECD countries published only very recently.
- No ROSCs available for Austria, Denmark, Netherlands, Spain.
- Some ROSCs updated recently, but others still available for 1999 data thus information dated and not a continuous data stream.
- No criteria for choosing countries in line with their presence in international capital markets.
- No public schedule of announcement of country coverage and coverage of codes.
- Coverage of codes heterogeneous.
- ROSCs not standardised.
- Limited information gained.



- Human and financial resources and capacity constraints are indentifiable as limitations on the BWIs serving as global monitors.
- One alternative would be greater use of self-assessment combined with a peer review process. The FATF model is as an example. The BWIs would still have an important role in co-ordinating the process and providing technical assistance to assist some countries in self-assessments and implementation.
- The BWIs could also play a useful role as depository of information and links to sources of information at country level on self-assessments, thus facilitating use of this information by market participants.

Resources

Resources required for assessment and implementation are expected to be large:

- Technical assistance offers a solution but the problem of global compliance across the world will strain both financial and administrative both at the domestic and international level.
- Human resources is also a problem, for example, trained personnel for banking supervision are scarce. Technical assistance to train supervisors is a solution, but

  1. It takes time to train.
  2. Incentives exist for human capital flight due to competition between the demand for supervisors at local level supervision and those required for global monitoring.

- Self-assessments backed by a peer review process offers the potential for ownership, independence and rigor
- Self-assessments can be supported by technical assistance where necessary
- It would minimize both the extraordinary cost and difficulty of managing a centralized monitoring system
- It would reduce the potential for conflict of interest by the Bretton Wood Institutions

But …

- Implementation of S&C is a process and requires qualitative assessments.
- Simplistic quantification and classification risk producing scoring systems capable of creating one-way expectations and bandwagon effects in the market.
- If market participants are left on the basis of self-assessments and peer review to make their own discretionary judgements on a country's level of compliance, there is a better chance of a more reasoned assessment.
- Use of quantitative scoring systems by multilateral agencies to meet market demand is likely to be counter-productive. Since the qualitative as well as the quantitative dimension of compliance is important, a purely or largely quantitative assessment framework contradicts the objectives of the whole exercise.

Incentives identified by IFI's for compliance with Standards and Codes

Positive incentives

- Self-interest.
- Technical assistance.
- Policy advice.

Incentives that could be directly applied by IFIs

- Making the access to IMF funds contingent on compliance in standards and codes.
- The implementation of certain S&Cs could be included in the conditions of an IMF adjustment program.
- The implementation of S&Cs could be a condition to Membership in international groupings.
- Obligate countries that do not implement S&Cs to pay higher charges for the utilisation of IMF funds is not under active consideration but remains one of the possible future step.

Incentives from 'the market side'

- Disseminate information on the compliance of S&Cs.
- Encourage private institutions to be concerned about the compliance of S&Cs and to include this information in their risk assessment.
- Restrict market access either for selected foreign institutions on the domestic market and for domestic institutions to selected foreign markets. Some examples of this may include: (i) banning the listing of a country's debt securities or shares and debt securities of companies resident there, on the sanctioning countries stock exchange, or (ii) banning the sale of these debt securities to investors resident in the sanctioning country.

Incentives structures may not work in the case of industrialised countries

Positive incentives

- Self-interest is muted because the recent crises have been domestic financial crises combined with external payments only in developing and transition economies.
- Reduced exchange rate risk compared to developing countries as it is possible for them to borrow in their own currencies.
- Do not need technical assistance as an incentive.

Official incentives

- Inapplicable as the industrialised countries no longer borrow from multilateral institutions.

Market incentives

- There is asymmetry in the way the market assesses the same information for industrialised, emerging markets and developing countries. For example, one of the G-7 countries does not comply with fiscal transparency but this does not seriously affect its credit rating or ability to borrow from private markets.
- Thus the idea that the market can punish for non-compliance through higher costs or drying up funds may not be valid for the industrial countries.

- If the market does not assimilate information as recent outreach activities and research shows, will negative official incentives be put to use?
- The functioning of the market is not perfect. If it assimilates information provided by a process that does not involve peer review and monitoring, will developing countries not be affected by lack of understanding and judgement?
- Conditionality can have an adverse consequence in that developing countries can also retaliate by limiting market access to the industrialised countries for lack of full compliance.

Asymmetries

- Asymmetry in the incentive structure for global participation. Industrialised countries do not borrow from BWI and therefore standards and codes are not binding on them.
- The codes are based on benchmarks appropriate to industrialised countries and their application is a potential source of comparative disadvantage, especially in the financial sector.
- Asymmetry in resource needs of various countries.
- Asymmetry in transparency - e.g. Information by hedge funds to developing countries

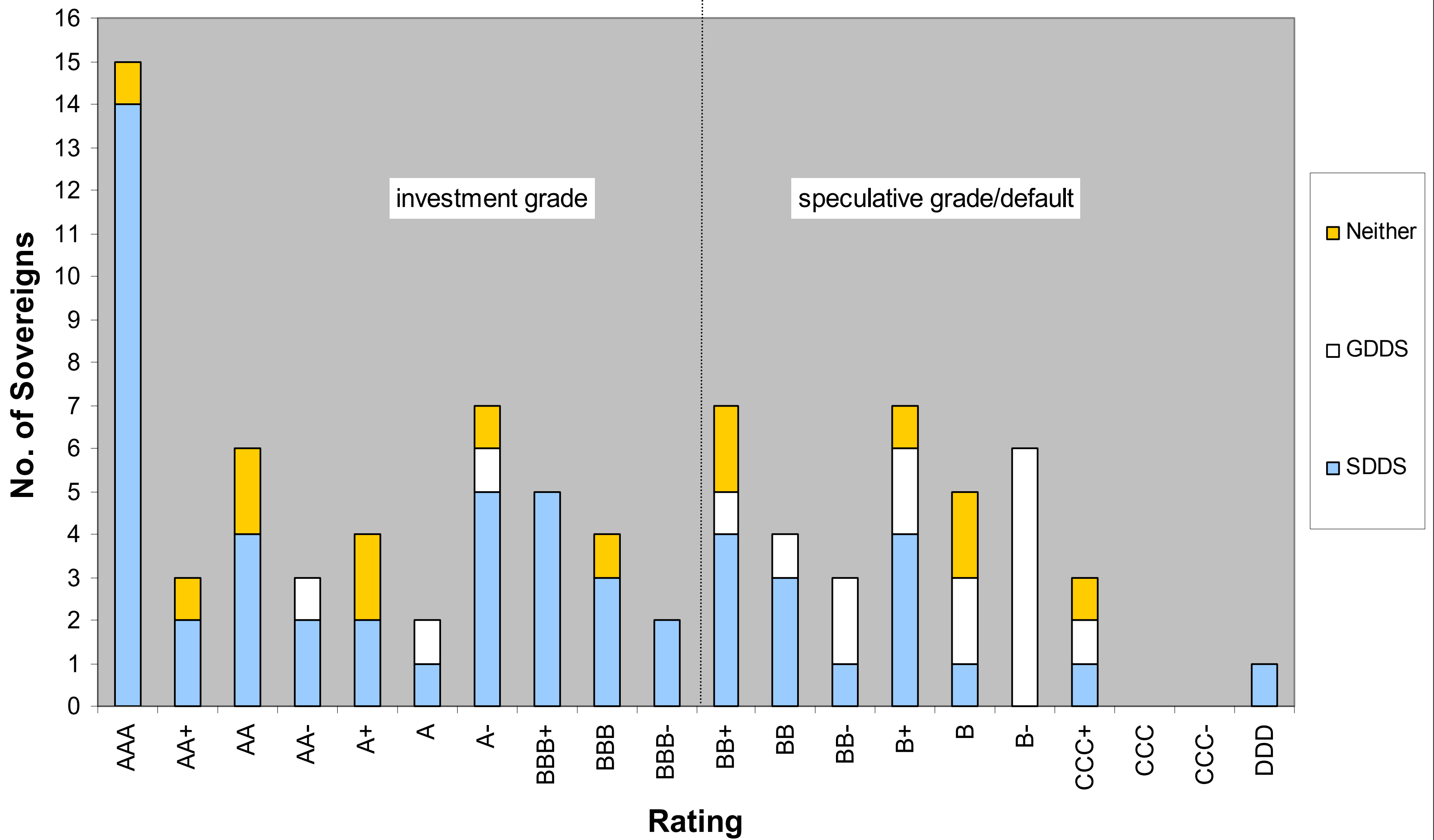
The international community shies away from endorsing action to require high-frequency disclosure of data on the large short-term positions in assets denominated in a country's currency held by foreign firms other than banks (a category including hedge funds), which several developing (and some developed) countries perceive as threats to the stability of their exchange rates and financial markets

- Asymmetry in jurisdiction. The World Bank has no jurisdiction over Part I countries.
- This asymmetry between developing and industrialised countries increases as we move away from using Standards and Codes as informing surveillance to include compliance in their lending decisions

- 57 out of 184 IMF member countries subscribe to SDDS.
- Incomplete information therefore remains a problem for world financial markets.

Mosley (2002) shows that the low level of compliance is due to:

- A weak market response.
- A weak government response.


Sovereign Ratings & SDDS/GDDS Subscription
(Source: Fitch Ratings and IMF)
No. of Sovereigns
Rating
investment grade
speculative grade/default
Neither
GDDS
SDDS
AAA
AA+
AA
AA-
A+
A
A-
BBB+
BBB
BBB-
BB+
BB
BB-
B+
B
B-
CCC+
CCC
CCC-
DDD

The impact of SDDS on spreads

Generalised Least Squares	log(Spread)							
	GLS		GLS with fixed effects		GLS with AR(1)		GLS with fixed effects & AR(1)	
Constant	5.52	*			5.75	*		
GDP grpwth	-0.05	*	-0.04	*	-0.02	*	-0.01	*
Long Terms Interest Rate	-0.04		-0.11	**	-0.37	*	-0.48	*
Debt Service as a % of Exports	0.04	*	-0.05	***	0.11	*	-0.19	*
Public Debt as a % of Export	0.02	*	0.02	**	0.04	*	0.02	
SDDS	-0.13		-0.21	***	-0.13		-0.19	
AR(1)					0.92	*	0.81	*
Fixed Effects Test			62.11	*			63.24	*
R2	0.95		0.98		1.00		1.00	
F	971	*	666		24580	*	2.E+11	*
DW	0.29		0.58		1.76		1.71	
Total panel observations	250		250		239		239	
Included observations	36		36		36		36	
Period 94.1-02.4								

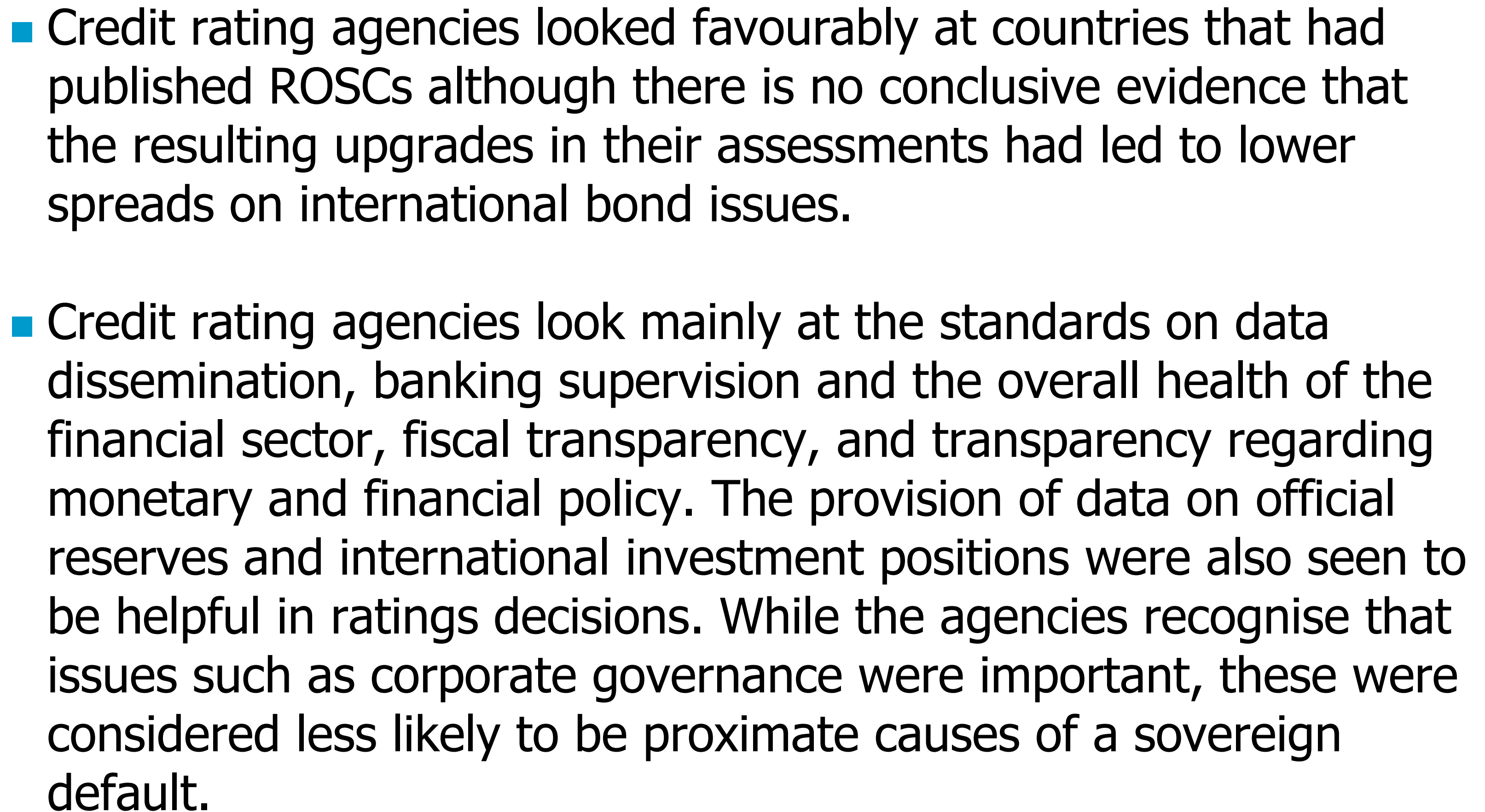
The estimation method is GLS (Cross section weights).

* denotes significant at the 1% level

** denotes significant at the 5% level

*** denotes significant at the 10% level

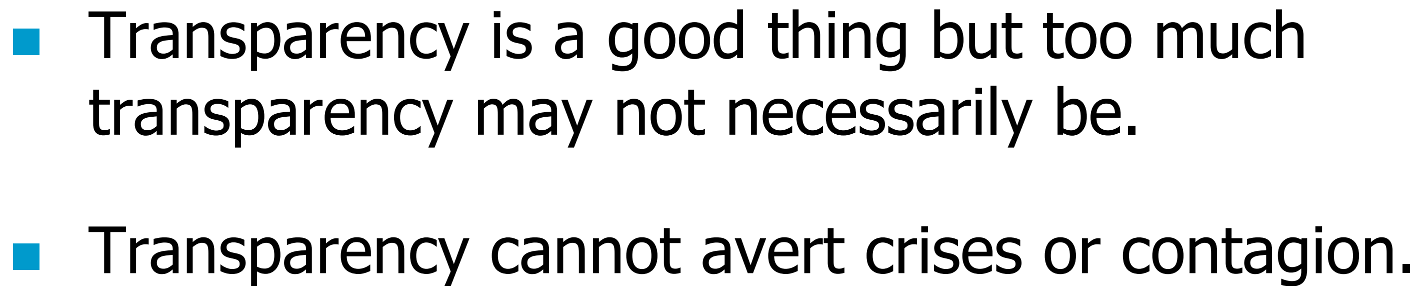
- The private sector has little interest in a public-sector driven approach and its interest in standards and codes exercise is a muted one
- The link between transparency and creditworthiness is not a straightforward one – the causality usually runs from creditworthiness to transparency
- Some of the information is not crucial to risk assessments and the value which the BWIs apply maybe too high
- What the exercise should do is to assess the vulnerability of the foreign exchange balance sheet



- Credit rating agencies looked favourably at countries that had published ROSCs although there is no conclusive evidence that the resulting upgrades in their assessments had led to lower spreads on international bond issues.

- Credit rating agencies look mainly at the standards on data dissemination, banking supervision and the overall health of the financial sector, fiscal transparency, and transparency regarding monetary and financial policy. The provision of data on official reserves and international investment positions were also seen to be helpful in ratings decisions. While the agencies recognise that issues such as corporate governance were important, these were considered less likely to be proximate causes of a sovereign default.

(Lionel Price, November 2003)



- Transparency is a good thing but too much transparency may not necessarily be.
- Transparency cannot avert crises or contagion.

During the East Asian crisis, adequate information was available to show the diversity in the economies hit by contagion.

Turkey and Argentina had problems even though they subscribe to SDDS.

- While in general stronger data standards will help market efficiency, the question is whether they are the panacea that is often assumed.
- There are some forms of disclosure that might even increase financial instability.
- Improved information flows have and will enable investors to allocate capital more efficiently.
- Disclosure, however, does not appear to warrant its central role in crisis prevention.

1. First, markets are as prone to crisis now as they ever have been, even though there has undoubtedly been some improvement in information flows.
2. Second, markets can sometimes turn “a blind eye” to information during bubble.
3. And finally at its limit, if better disclosure ultimately reduces the diversity of investor opinion, this could actually contribute to greater financial instability.

(Metcalfe and Persaud, November 2003)

FSF Report, September 2000

But a shift in emphasis is now perceptible…

as in some cases it is already a part of **soft conditionality**

Ecuador was required to publish the ROSC report on data dissemination in order to secure a Stand-by Arrangement with the Fund.

- Uruguay's Stand-by Arrangement included recommendations of Fiscal ROSC
- Ghana's arrangements for a Fund Program included recommendations of financial sector ROSCs
- Brazil's Stand-by Arrangement included recommendations of the Corporate Governance ROSC

The arguments against conditionality

- There is stress between ownership and conditionality.
- Developing countries are already overburdened with conditionality of which there is already a recognition. Equally there is a need to streamline conditionality in line with their original intention to enhance the financial health of the organisations concerned. How will the IMF streamline conditionality if a new raft of new conditions is added?
- There is no economic proof that standards and codes are effective in developing countries. It is important to apply them them but they are not any insurance against crisis. Recent problems in corporate governance have demonstrated that there are inefficiencies even in some best practices and problems are possible with effectiveness in the industrial countries as well.

‘Ownership’ of polices crucial to achieve implementation

- ‘Ownership’ will not come without the representation of developing countries’ issues and concerns. Ownership cannot be imposed from outside.
- ‘Ownership’ comes with appropriateness - ‘one size fits all dilemma’.
- Although there is recognition in principle about the problems resulting from the varying stages of development and institutional capacities, real solutions are required.
- Self-interest is the best incentive.

Capital Adequacy

Rojas-Suarez (2002) shows that:

Capital adequacy was not a good indicator in developing countries. Net equity capital was high and positive in developing countries that faced a banking crisis in the 1990s but negative in the case of industrial ones.

- The reasons for limited effectiveness are:

  (i) Lack of liquidity for bank shares, subordinated debt and other bank liabilities that are needed to validate 'real' value of capital from its accounting value.

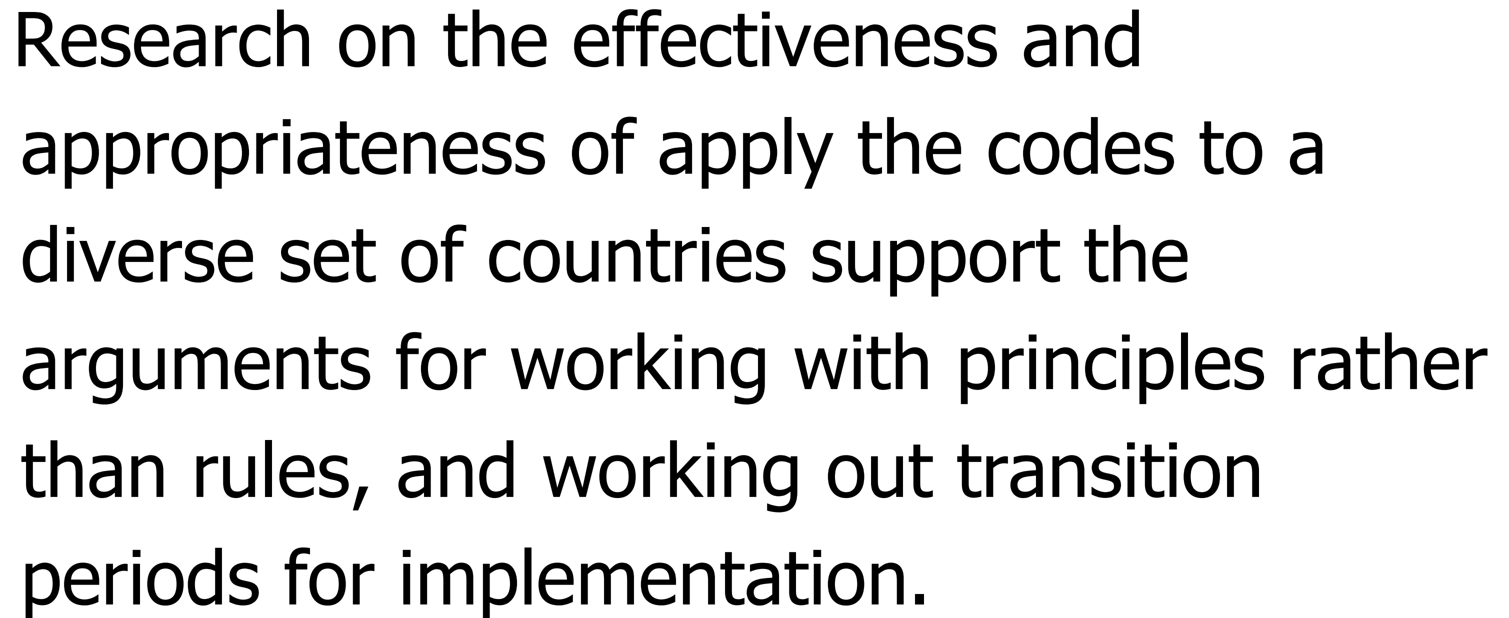
  (ii) Inadequate capital requirement and regulatory framework.

  (iii) Degree of financial development an important factor for capital standards to be effective.

Capital adequacy can weaken the banking system in developing countries.

- As the regulatory treatment of bank claims on governments tends to reduce the soundness of the banking systems in emerging markets.

- The risks inherent in opening up the capital account require a well thought out preparatory stage and hence the growing acceptance for gradualism.
- The principles behind standards and codes are also some of the pre-conditions identified for the opening up of the capital account.
- Priority setting and sequencing therefore needs to be linked to the sequencing of the capital account opening and strategic integration in global capital markets.
- Implementation of standards and codes will be a gradual process. More research efforts are needed to determine appropriateness in diverse conditions, sequencing and whether it really ensures financial stability.


Research on the effectiveness and appropriateness of apply the codes to a diverse set of countries support the arguments for working with principles rather than rules, and working out transition periods for implementation.

How do we ensure stability in the transition period?

The prioritised 12 codes will take years to implement. How is financial stability to be ensured in the transition period? Moreover, we do not know enough to be sure that even at the end of the transition period the 12 codes will encourage financial stability. Financial crises have many causes and the danger is that too much emphasis on standards can detract attention from other policy measures.

1. A new orientation needs to be given to the standards and codes exercise.
2. It maybe better to focus on financial sector reforms and use standards and codes as a benchmark for all countries to benchmark their reforms
3. The standards and codes exercise can contribute to global financial stability only in the long run.

Open questions

- Can we ensure global participation of countries in the implementation of standards and codes? Is implementation a good idea for all countries?
- How do we ensure global surveillance for standards and codes compliance?
- Is there a case for separating monitoring of standards and codes from lending operations to ensure global financial stability?
- Who is responsible for providing information? Is the private sector the answer?
- What measures can the international community take to ensure that there is reciprocity in transparency?
- Do principles work better than rules?
- Do we need the same model of corporate structure globally?
- Is it not a good idea to encourage self-assessments on compliance?
- Are suggestions that standards and codes be incorporated into conditionality a good idea?
- What is the way forward?
- How do we resolve the constraints on resources needed for implementation? How do we improve ownership and self-interest?
- Should the emphasis not be on sound balance sheet management?
- Is the initiative enough to ensure global financial stability? How do we ensure stability in the transition period?