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Statement of the Shadow Financial Regulatory Committee

On

PRINCIPLES FOR REFORMING THE "GLOBAL FINANCIAL ARCHITECTURE"

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In recent weeks, President Clinton and Prime Minister Blair, among others, have called upon other countries to discuss ways in which the "global financial architecture" might be improved. These calls have been prompted by instability in world financial markets in the wake of the Asian financial crisis, the recent devaluation of the ruble, and the moratorium Russia has placed on repayment of many of the country's debts.

In response to these events, there have been suggestions that markets need the guiding hand of more extensive regulation, especially by international institutions, to restore stability. Some have advocated restrictions on capital flows between countries for the same reason.

The Committee believes that, to the contrary, events over the past year demonstrate that governments and international financial institutions, such as the International Monetary Fund (IMF), have undermined market discipline by lending to countries whose currencies have been under pressure. In addition, many countries themselves have failed to ensure a proper role for market discipline in their own financial systems. Accordingly, the main objective of future reforms in the "financial architecture" should be to find ways to ensure that markets work better, rather than to have markets displaced or restricted.

Toward this end, the Committee offers the following specific principles it believes should be an integral part of any reforms of the international financial system. Some of these principles should be adopted by individual countries. Others should be adopted by the IMF.

Principles For Countries

1. Deal Expeditiously With Insolvent Institutions

Countries with insolvent financial institutions should promptly resolve them. Delaying this process - "regulatory forbearance" - invites further risk-taking by their owners, especially of banks, whose deposits tend to be implicitly or explicitly ensured by governments. Furthermore, governments can and should minimize the cost of resolving their financial difficulties by being open to long-term foreign direct investment.

2. Adopt and Enforce Capital Standards

Countries should adopt and strictly enforce sufficient capital standards for depository institutions. Policy makers in the United States have found that a system of "prompt corrective action" - whereby regulators are required to apply automatic and progressively stiffer penalties to banks and thrifts as their capital positions dwindle - has been useful in encouraging depositories to fully capitalize and discourage excessive risk-taking. If they have not already done so, other countries should adopt a similar system.

3. Encourage Market Discipline

Governments should explore ways of encouraging more market discipline of their financial institutions to supplement and strengthen regulation and supervision. This becomes increasingly important as the complexity of financial activities outstrips the ability of regulators to stay abreast of current techniques and developments. The Committee has previously suggested, for example, that bank regulators require large banks to back a certain portion of their assets with uninsured, subordinated term debt, which would ensure a greater role for market discipline.

4. Maintain Free Flow of Capital

Governments should preserve the free flow of capital across national borders, with very limited exceptions. It might be appropriate for countries with troubled financial institutions to discourage borrowing in foreign currency, especially at short maturities. Otherwise, maintaining the free flow of capital is essential for facilitating trade and growth around the world.

Principles For Reform of the IMF

The Committee believes that the current debate in Congress over additional funding for the IMF affords a unique opportunity to implement reforms that can enhance the role of market discipline throughout the world and curtail the "moral hazard" associated with past IMF rescue efforts. Indeed, the Committee believes that such further funding should not be provided unless at least the following reforms are made.

1. Incentives for Financial Reforms By Countries

The interest rates at which the IMF extends loans should take into account the extent to which countries adhere to the principles listed above, especially their adherence to the principles governing the regulation and supervision of their financial systems.

2. Discipline Foreign Currency Creditors

As the Committee stated in May 1998 (Statement No. 145), the IMF should seriously consider the adoption of a "conditional haircut" system for foreign currency creditors of banks, the actors in the financial system who have been most insulated from loss in previous IMF rescues (because the proceeds of the loans tend to find their way to the banking systems, and thus to the creditors of banks). Under the Committee's proposal, IMF lending (or at least the interest rates on its loans) should be conditional on countries having a system in place that automatically subjects the foreign currency loans made by creditors of banks to a haircut unless those creditors roll over their loans or otherwise do not withdraw their funds. In addition, governments should avoid extending guarantees of those loans. Such a system would promote stability (by keeping funds in a country in a crisis) and curtail moral hazard by confronting foreign currency lenders with potential losses, which they would factor into the rates they charge in the future.

3. Accounting For IMF Assistance

The IMF should require countries receiving assistance to provide a fuller account of how they have spent the proceeds of their IMF loans. The Committee recognizes that money is fungible. Nonetheless, frequent reports on the flows of funds of countries receiving assistance would help the Fund, its members, and also the public to understand how effectively the additional resources have been used.

4. Fuller Disclosure

The IMF should work with all of its members to improve the timely availability of key financial data on the accounts of governments, central banks, and commercial banks to help market participants make more informed judgments. Of particular importance are data on net international reserves (gross reserves minus forward currency commitments) and total foreign currency borrowing.

5. Objectives and Accountability

The IMF should clearly articulate its goals and the ways in which it would measure success in achieving them. The IMF should use these criteria in regular reports to its members on the extent to which those objectives have or have not been met.