The evolving role of the IMF in the light of the 1994/95 Mexican crisis

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In this article, Jon Shields describes how the role of the IMF has developed since the Mexican crisis in 1994/95, which prompted the largest international support operation ever undertaken. He sets out the background to the crisis, including the rapid expansion of international capital markets, how the crisis was resolved and the lessons learned from it. Since then, the Fund has acted to improve the quality and extent of data that countries provide, and to enhance its own surveillance. It has also improved its procedures for allowing rapid financial support to be given and taken steps to ensure the adequacy of resources available to the Fund. Two possibilities still under consideration by the Fund are identified: burden-sharing with other creditors and adding the liberalisation of capital controls to the Fund's objectives. Jon Shields concludes that though risks remain, the changes made by the Fund have put it in a better position to deal with another crisis such as that in Mexico.

Background

On 1 February 1995, the IMF agreed a standby credit to Mexico of nearly $18 billion. At the same time, the US government agreed credits worth a total of $20 billion. This was the largest international support arrangement ever made; the Fund's contribution exceeded its normal guidelines for credit ceilings by a factor of nearly five.

Many of the circumstances leading up to these arrangements were unique to Mexico. But the size of the support provided and the fact that Mexico had previously been regarded as an example of successful economic adjustment—and had recently joined the OECD—encouraged a wide-ranging debate about the criteria by which countries' success was judged and how to give assistance. This debate took place against the background of ever-growing international capital markets, as described in the box on page 302.

In particular, questions were raised about the role and power of the IMF in the context of massive flows of private capital:

- Why had the Fund not been able to warn Mexico of the risks that it faced?
- Was the Fund's analysis sufficiently penetrating to provide warning signals of changes in market confidence?
- Were the markets properly supplied with information?
- Should the Fund be using its financial resources to attempt to change the direction of large capital flows?
- Were the Fund's resources sufficient to contemplate such action in the future?
- Had the policy prescriptions applied with Fund support during the late 1980s and early 1990s been at fault?
- Did the Fund need new financial facilities?
- Were there structural problems in international capital markets that threatened coherent policy-making?

These issues are all still very much with us. But the Fund and the international community have made considerable progress over the last two-and-a-half years in identifying possible weaknesses in approach and developing ways of responding to potential problems. The Fund in particular has adjusted its attitudes and activities in several crucial areas.

The central questions have been whether the international financial system has changed fundamentally during the last decade and, if so, whether the Fund has adapted quickly enough. As markets have opened up and the role of international private finance has been seen as increasingly beneficial, differences of opinion have widened over whether public institutions can and should exercise power over global capital flows. Some have warned that governments and inter-governmental institutions need to reassert their capacity to prevent unfettered markets exercising too much influence over domestic policies. Others have seen free, well-informed markets as instruments that are always more efficient than public sector agencies at allocating resources and putting pressure on governments to adopt responsible domestic policies. In between are those

Capital flows

Financing in international capital markets (defined as the sum of new international loans, notes, bonds and equities) has tripled over the last eight years in dollar terms. This dwarfs official flows.

In industrial economies, the predominance of prudent monetary policies, the elimination of capital controls, a willingness outside the ERM to permit exchange rates to float freely and the proliferation of instruments and intermediaries (including other central banks) to provide credit have all but eliminated calls for co-ordinated international support or IMF finance in times of difficulty.

This is not yet the case for emerging markets or poorer developing countries. Nevertheless, the options for using private rather than multilateral official credit have increased substantially. As countries with market access have used these options more and more effectively in good times (through inward direct investment, bank credit, public or private foreign currency bond issues or external purchases of domestic currency securities, as well as private equities), so the potential to cover large financing gaps in bad times has also increased. Such financing can be risky, but it is generally possible to organise as long as some measure of confidence is maintained and other shocks have not imperilled the supply of funds. Meanwhile, there has been a five-fold increase in total private net capital flows to developing countries and countries in transition in the last six years, albeit concentrated on a handful of Asian and Latin American countries.

The composition of private capital flows has also shifted. In the 1970s, international banks provided much of the private capital resources to the public sectors of the faster-growing developing countries, through foreign currency loans carrying explicit guarantees from the governments of the borrowing country. Policies of high growth seemed certain to assure timely repayment and the banks had adequate funding, particularly through the recycling of petro-dollars. But borrowing countries' abilities to maintain financing of their loans proved very susceptible to appropriate domestic policies and external shocks, especially commodity prices and international interest rates. By 1982, many countries (in particular in Latin America, most clearly Mexico) were unable to continue to service their interest payments. The resultant crisis was, however, responsive to action by the international financial community and creditors together, though over a long period and at considerable cost to the debtor countries. Support operations provided new official finance while protracted negotiations opened with the major banks to agree on terms to settle outstanding claims and eventually open the way to new private finance.

The lesson that reliance on floating-rate and essentially short-term bank debt could dangerously increase the vulnerability of both emerging markets and banks was learned effectively by both borrowers and lenders. Banks became much more wary. Securitisation seemed a safer option. Bond markets grew more extensive and more sophisticated with greater resources available. So as countries emerged from the debt crises of the 1980s, with more liberalised systems and macroeconomic policies centred on a prudent fiscal position and steady monetary growth, they turned increasingly to international bond markets.

This formed part of a general surge in portfolio inflows into what were by then termed 'emerging markets'. In 1990, nearly one third of such inflows were from bank and other credits. By 1993, this share had dropped to one fifth.

who want to see markets with a dominant role but who are anxious to ensure that market failures do not cause excessive volatility; furthermore, if countries make mistakes, they want the speed and cost of correction to be optimised through official assistance.

Under the 'minimalist' approach, the IMF would simply provide information and advice to member countries and markets, and possibly facilitate private sector support. Under the 'interventionist' approach, it would continue to provide finance as needed, conditional on the implementation of sounder policies.

The Mexican crisis

Mexico in the early 1990s benefited considerably from the rapid development of international capital markets. Between 1990 and 1993 it received net capital inflows worth about 8% of GDP per year and totalling \$91 billion, about one fifth of all such inflows to developing countries. Two thirds of Mexico's net inflow was portfolio investment.

During 1994, external holdings of short-term public sector debt rose particularly rapidly. This partly reflected a major shift in debt management policy. As uncertainty about domestic developments pushed domestic yields higher and external financing needs rose in the face of a current account deficit approaching 8% of GDP, the Mexican authorities issued a new form of short-term debt, the 'tesobono'. These bills, though formally designated in local currency, with high peso yields, contained exchange rate guarantees that made them equivalent to high-yield US dollar debt and hence very attractive to foreign holders. By the end of the year 85% of the \$20 billion of foreign holdings of Treasury bills were in tesobonos and total short-term external debt (maturing within a year) exceeded \$67 billion. Meanwhile, Mexico's gross foreign exchange reserves declined from $30 billion in February 1994 to $6 billion in December.

Even if confidence had remained high, it would have been difficult to service this short-term debt through new borrowings. But the announcement of a 15% devaluation on 20 December sparked a widespread reassessment of Mexico's position. Markets and international authorities quickly came to the view that Mexico would find it impossible to meet its obligations without a co-ordinated package of support and tighter policies. The peso and the domestic stock market crumbled.

So there were two issues at the heart of the Mexican crisis. First, the existence of massive foreign currency requirements in the short term, with no obvious sources of finance. Second, the collapse of confidence because of growing evidence that Mexico's economic policies had strayed from the prudent line on which its reputation had been rebuilt, and that its banking system was ill-prepared for currency shocks.

Linking these developments, and amplifying their effect, was a shortage of hard information to markets. There had been little recognition in the year leading up to the crisis of the extent of pressure on Mexico's reserves, or the means that it had used to fill the gaps. Moreover, the expansion of domestic credit had gone largely unnoticed. This meant that when the reassessment took place, it involved a major shift in perception over a very short period of time. There were also wide differences in understanding about the nature of the economy and policy formulation. Many domestic players were able to respond very quickly—some seemingly just in anticipation of the devaluation—leaving some international investors in panic at the rapidly falling markets.

Crisis resolution

In theory, some sort of 'market solution' should have been possible even in the depths of the crisis. A combination of reduced payments on debt-servicing obligations and firm undertakings on policy corrections might have provided the basis for new finance that could have seen Mexico through—albeit at the cost of a substantial devaluation, falling activity and higher future borrowing costs. But that would have been extremely difficult to organise with creditors widely dispersed and no way of binding the government on future actions. And with the ultimate level of compensation uncertain, individual investors might well have preferred simply to unload their stock as quickly as they could, a 'rush for the exits'.

To overcome such difficulties, the international community, notably the Fund and the US government, stepped in to provide sufficient finance to prevent Mexico from defaulting and to support the policy changes announced by the Mexican government. The problem was that such action also then 'bailed out' holders of tesobonos and similar securities. Though these holders had been receiving very high yields to compensate for the theoretical risks involved, when it came to the ultimate risk—of non-payment because of a currency crisis—they found themselves fully protected.

International support

The prime need was to restore market confidence at minimum cost to the international community. Risks were seen not only to Mexico itself but also to other countries in the region and in similar positions. Such contagion—the so-called 'tequila effect'—was evident from the earliest days of the Mexican crisis. Other Latin American countries, particularly Argentina and Brazil, saw falls in their stock markets and pressure on their currencies. Banking systems came under severe strains. Some Asian emerging markets, such as Thailand, also suffered the effects of reduced confidence, as investors retreated from these and other markets perceived to be similar in character to Mexico. The impact was accentuated by better returns in industrial economies. Some commentators even warned of 'systemic' risk if confidence failed simultaneously in a number of markets. A Mexican default on its debt was feared for its knock-on effects on all bond markets; and a return to exchange controls would have set back the liberalisation of currency markets by many years.

The credibility of economic adjustment was also an issue. Mexico had been seen as a great success story as it had adopted stability-oriented macroeconomic policies and structural reforms under IMF programmes and guidance. Low inflation, a predictable exchange rate and steady growth were seen as signs of stability, reinforced by the involvement of Mexico in the North American Free Trade Association (NAFTA). Membership of OECD was seen as further confirmation of Mexico's graduation from developing to industrial country status.

So the problems that Mexico faced in 1994 were viewed by the international community not as the consequences of a failed economic framework, but as arising from errors made over a relatively short period. With hindsight, it became clear that the exchange rate had been maintained at an unsustainably high nominal rate against the backdrop of a swelling current account deficit and higher inflation than its competitors. Rising US interest rates accentuated the problems. The policy mix had been wrong. Swings in market confidence caused by political events during 1994 (the Chiapas revolts and political assassinations) had not been addressed by coherent economic policy responses. The hiatus between the Presidential election on 21 August and the swearing-in of a new government on 30 November had allowed domestic credit to continue to expand rapidly. The restructuring of government debt towards short-term notes with exchange rate guarantees had been misconceived. Data to which markets had been accustomed during Mexico's programmes with the IMF (which finished in 1992) were no longer being made available; and there were serious weaknesses in the banking system associated particularly with loans to companies with high foreign exchange exposures.

A resolution of the Mexican crisis was particularly important to the United States because of NAFTA, common borders and mutual investments. But efforts by the US Administration to persuade Congress to provide substantial guarantees to Mexico (up to $40 billion) proved unsuccessful and were abandoned on 31 January 1995. These were to have been supported by a conventional, but nevertheless very large, Fund programme. The object was to demonstrate to the markets both that Mexico's short-term financing needs could be met and that the IMF and United States believed that Mexico's planned economic policies would be sufficient to stabilise the economy.

In place of the intended US support operation and an IMF package of $7.8 billion, the IMF agreed at very short notice—within two days—to increase substantially its own potential financial contribution to $18 billion, complementing $20 billion from the US Exchange Stabilisation Fund and promises of other support from the international community. The IMF contribution was in the form of a 'standby' arrangement, which made SDR 12 billion of foreign currency available in tranches over an 18-month period. The total amount of finance was seven times the size of Mexico's quota (or shareholding) in the IMF; normally, there is a ceiling on annual credit disbursements equal to the member's quota. In addition, a much greater proportion than normal of this credit was disbursed at the beginning of the arrangement.

Market turbulence continued for some time. Nevertheless, Mexico managed to service all of its outstanding obligations and re-enter private capital markets within a few months. By mid 1996, it was able to repay a substantial proportion of the US loan, to begin reimbursing the IMF and to give undertakings that it would not draw upon its remaining entitlement under the (extended) IMF programme. The costs of the crisis to Mexico were severe—recorded unemployment doubled, output fell by 6% in 1995, bank support operations cost 6½% of GDP and inflation surged for a while above 50%—but Mexico's recovery now seems to be well under way.

Lessons of the Mexican crisis

The Mexican crisis was particularly disruptive because policy errors were identified at a very late stage, after a rapid build-up of foreign currency liabilities. Efforts at preventing such crises in the future have therefore concentrated on providing better 'early warning indicators'. These rely on the timely provision of reliable information by country authorities and coherent assessments by markets.

The ability to judge whether policy is sustainable is also an issue. This is particularly important when price indicators have been suppressed, such as when fixed or crawling exchange rates are being used as anchors to policy. In addition, it is important to assess the capacity of the infrastructure, especially in the banking and wider financial sector, to withstand necessary policy adjustments, such as higher interest rates or fiscal consolidation.

If policies fail, restoring market confidence demands a coherent and substantial response by national authorities and the international community. They must be able to demonstrate that financing needs can be met in the short term and that effective policy corrections will be maintained over the medium term. This can only be done on a case-by-case basis.

Intervention must avoid creating problems of moral hazard. If some parties—particularly groups of creditors but sometimes also policy-makers in the affected countries—are seen to have been protected against the consequences of their errors, support operations will be questioned and market allocation mechanisms disrupted because of expectations of future bail-outs. Future actions will then prove even more expensive.

The Fund and other international groupings, such as the G7 and G10, have been looking in some detail at these issues and have taken a series of measures to help resolve some of the perceived deficiencies. These can be grouped under four headings:

- Better information (data and Fund assessments).
- Improved surveillance.
- Speedy financial support.
- Adequate resources.

Better information

(a) Data

The economic importance of private capital flows, which can sometimes be extremely volatile, makes it crucial that markets receive timely and accurate information about the economy and economic policy. This enables markets to adjust expectations continually, so that any necessary corrections to price or availability of finance can be made smoothly and consistently. Otherwise, assessments can change precipitously, and then price changes are more likely to overshoot and finance effectively to dry up. Similarly, if information is not shared widely, different assessments can lead to inefficient market allocations, and possibly a drastic correction once details are more widely disseminated.

Crucial data relate to the current account of the balance of payments, a country's gross foreign exchange reserves and the level and composition of its external debt. It is always tempting for authorities to try to cover up problems to avoid additional costs of finance or painful policy adjustments. Normally, however, such withholding of information simply delays the correction, which imposes higher total costs.

Most financing problems can be predicted on the basis of standard macroeconomic data and knowledge of the stance of economic policy. So timely publication will enhance the ability of both markets and domestic authorities to identify forthcoming problems. The Fund has for a long time

Special Data Dissemination Standard (SDDS)

The Fund's Special Data Dissemination Standard (SDDS) identifies a set of minimum statistical requirements for macroeconomic data. It is targeted at countries with, or seeking, access to international markets. Participation is voluntary; so far 42 countries have subscribed, including all the major industrial economies and emerging markets such as Thailand, Hungary and Mexico. Some countries are taking advantage of the transitional period (up to the end of 1998) to bring their data fully up to the required standards.

The SDDS has four dimensions:

(i) *Coverage, periodicity and timeliness*. All the main macroeconomic data sets are included: output, inflation, employment, fiscal deficits and accounts, public debt, monetary aggregates, interest and exchange rates, balance of payments, external reserves and external debt. Some should be reported daily; others weekly, monthly, quarterly or annually. The SDDS also specifies how promptly all data should be published.

(ii) *Access by the public*. The SDDS requires publication of release calendars and simultaneous release of data to all interested parties, so that access is easy and uniform.

(iii) *Integrity*. To allow users to assess how much confidence they should place in the integrity of the data, the SDDS specifies that they should be told how the data are produced; whether government is allowed access to data before publication, and comments on it on release; and when revisions are made to data or methodology.

(iv) *Quality*. Certain procedures that should give some indication about quality are specified, such as public documentation of methods and sources; and release of component details and reconciliations that allow cross-checks.

Information about all of the subscribing countries' data is available on a bulletin board that the IMF has established on the Internet. The address is http://dsbb.imf.org. There are now also hyperlinks to the actual data for a number of countries, together with a summary data page on the bulletin board.

advocated production of regular high-quality macroeconomic data and demanded the provision of such data if countries are pursuing IMF-supported programmes. Under its Article IV surveillance procedures, it has also documented the data available and pointed out weaknesses. But it has not in the past intervened very much in the public availability of data, other than to re-publish data in standardised format (sometimes with considerable delay) in its *International Financial Statistics*. Indeed, the Fund has no jurisdiction over the publication of statistics. It can only hope to use its influence to encourage good practice.

The Mexican crisis convinced the Fund that it should do more to encourage more consistent data provision. The result, after extensive debate about how to strike a reasonable balance between uniformity and flexibility, was agreement in April 1996 that the Fund would set up its own 'Special Data Dissemination Standard'. This sets minimum requirements for macroeconomic data in terms of coverage, frequency, timeliness, quality, integrity and availability. It was intended for countries which have or seek substantial access to international capital markets. Particularly important provisions under the data standard are the publication, within a week of the end of the calendar month, of monthly levels of international reserves and regular data on the balance of payments, monetary aggregates, fiscal accounts, inflation and growth. More than 40 countries (including Mexico and the United Kingdom) have already subscribed to this standard. Their procedures can now be viewed on the Internet. In addition, many have established links between the Fund Internet site and their own data (see the box above). Markets should now be able to identify any slippage in coverage quickly and put pressure on the relevant authorities to provide missing details.

The Fund has also tightened up its own requirements for data provision by countries. This ensures that surveillance is conducted consistently and deeply, and also warns a country's peers if there are important deficiencies. Technical assistance can be made available to help countries with poor data.

The Fund is also developing a 'General Data Dissemination System' that can apply to a wider group of countries, including those who do not at present rely much on international capital markets. The system is intended particularly to help such countries to improve the quality and delivery of their data. This will help them to focus their efforts and ensure that a basis is laid from which they can eventually meet the stricter requirements of the Special Data Dissemination Standard.

(b) Fund assessments

The Fund has become conscious of the need to make its own assessments more public, so that policy sustainability is accurately and consistently judged. The Fund's assessments cover both the state of a country's economy and judgments about the appropriateness of economic policies; they increasingly include structural, as well as macroeconomic, aspects.

The Fund has published an expanding range of material in recent years. For instance, in addition to its assessments of the *World Economic Outlook* and *International Capital Markets*, background reports on economies undergoing Article IV surveillance are now frequently made available. Under the Article IV procedures, consultations are held between staff and every member country, normally once a year. These start with a visit to the country by a small staff mission and conclude with a detailed staff paper, including an objective appraisal, and discussion in the Fund Executive Board. The consultations are designed to help each member evaluate its policies through peer review. Summaries of Article IV assessments are published in the Fund's annual report and often drawn upon in the monthly *IMF Survey*. Speeches or articles by Fund management provide further information, sometimes with clear warnings.

The latest innovation is a series of 'Press Information Notices'. These are published at a country's discretion, following conclusion of the annual Article IV consultations. They summarise background information about the economy given by Fund staff to the Executive Board and indicate the views expressed by the Board about economic and policy developments. They can include specific warnings about the direction of policy and make recommendations for change, although highly market-sensitive judgments are likely to be excluded.

Some have advocated going even further. They would like to see confidential staff reports also published. This would make the process more transparent. But in doing so it might also reveal details of discussions between Fund officials and Ministers and civil servants about the possible direction in which policies might develop. This might reduce the amount of information that officials were prepared to discuss with the Fund and thus the value of surveillance. If the trade-off is between transparency and quality, the choice at the moment is to preserve quality (though it is understood that openness might also improve incentives for higher-quality work).

Even more contentious is the suggestion that Fund management should give clear, public warnings if at any time they perceive a country's policies as being dangerously disruptive. Such warnings would be intended to have a powerful impact on policy-makers and markets. The risk of course is that markets might over-react. But an early correction by the markets might prove to be much less harmful than delayed reaction caused by a failure to identify policy errors and risks. It might also prevent unjustified contagion.

Sometimes it is as important for the Fund to issue general statements about policy as it is for it to make statements about specific countries. Messages about the necessity of sustainable fiscal policies, the value of freely convertible currencies and the importance of properly regulated banking systems have been clearly and regularly enunciated by Fund management. But the Fund has gone further than this in recent years. Following the 'Madrid Declaration' at the 1994 Annual Meetings about the immediate prospects for global economic policy, the Governors of the Fund (through the advisory 'Interim Committee') adopted a statement called the 'Partnership for Sustainable Global Growth' in October 1996. This promulgated what the Fund's Managing Director, Michel Camdessus, has called the 'Eleven Commandments' of economic policy. These make clear the importance of sustained fiscal discipline, open economies, market-friendly structural policies and good governance (see the box on page 307). They provide effective guidance for individual governments and important criteria for the markets, with the stamp of global approval.

Improved surveillance

The Fund recognises, however, that promulgating a message is not the only issue. The message itself must be timely, correct and absolutely clear. In the case of Mexico, there was a perception that the Fund—like the markets—had failed to see how risky the situation had become and had failed to warn the authorities clearly of policy errors. Though it was understood that the rising real exchange rate (resulting from a nominal exchange rate band and a relatively high domestic inflation rate) would be difficult to sustain against current account pressures, and that the banking system was not sufficiently robust to withstand large exchange or interest rate changes, the onset of the crisis caught the Fund largely unawares.

Ideally, the Fund's annual Article IV surveillance process would have identified the problems at an early stage and provided a vehicle for recommendations of policy changes. Under this process, Fund staff assess in detail the state of the economy, the policy stance and economic prospects. In addition to traditional concerns about macroeconomic policy, such as whether monetary policy can deliver a sustainable balance of payments position, if fiscal policy is supportive and what the impact is of any restrictions on the exchange rate on trade, staff are looking increasingly at structural policies. This reflects an appreciation that macroeconomic policy can only deliver high growth and low inflation if markets are not restrictive and public sector management is efficient. So labour, product and financial markets, public involvement in productive industry and governance considerations, including public spending control and fiscal transparency, have become important areas of interest.

The problem in the past was that, having assessed this information and come to a view on the sustainability of policies, staff would be wary of taking too obviously critical a line. Cautious about their judgments and conscious of political sensitivity, they would tend to wrap up the conclusions in 'Fundese'—a mixture of economic jargon and understatement. This made it too easy for national authorities not to hear the message.

Fund staff are now encouraged to be much more direct in their conclusions. Not only are they asked to focus their efforts on areas that might need improvement, but they are

The 'Eleven Commandments' of economic policy

In its 'Partnership for Sustainable Global Growth' statement, agreed in October 1996, the Interim Committee of the IMF declared that it attached particular importance to the following:

1. Stressing that sound monetary, fiscal and structural policies are complementary and mutually reinforcing: steady application of consistent policies over the medium term is required to establish the conditions for sustained non-inflationary growth and job creation, which are essential for social cohesion.

2. Implementing sound macroeconomic policies and avoiding large imbalances are essential to promote financial and exchange rate stability and avoid significant misalignments among currencies.

3. Creating a favourable environment for private savings.

4. Consolidating the success in bringing inflation down and building on the hard-won credibility of monetary policy.

5. Maintaining the impetus of trade liberalisation, resisting protectionist pressures, and upholding the multilateral trading system.

6. Encouraging current account convertibility and careful progress toward increased freedom of capital movements through efforts to promote stability and financial soundness.

7. Achieving budget balance and strengthened fiscal discipline in a multi-year framework. Continued fiscal imbalances and excessive public indebtedness, and the upward pressures they put on global real interest rates, are threats to financial stability and durable growth. It is essential to enhance the transparency of fiscal policy by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits.

8. Improving the quality and composition of fiscal adjustment, by reducing unproductive spending while ensuring adequate basic investment in infrastructure. Because the sustainability of economic growth depends on the development of human resources, it is essential to improve education and training; to reform public pension and health systems to ensure their long-term viability and enable the provision of effective health care; and to alleviate poverty and provide well-targeted and affordable social safety nets.

9. Tackling structural reforms more boldly, including through labour and product market reforms, with a view to increasing employment and reducing other distortions that impede the efficient allocation of resources, so as to make our economies more dynamic and resilient to adverse developments.

10. Promoting good governance in all its aspects, including by ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption, as essential elements of a framework within which economies can prosper.

11. Ensuring the soundness of banking systems through strong prudential regulation and supervision, improved co-ordination, better assessment of credit risk, stringent capital requirements, timely disclosure of banks' financial conditions, action to prevent money laundering, and improved management of banks.

asked to be more explicit about their findings and recommendations. The emphasis is on selectivity in approach and frankness in presentation.

The last two years have also seen demonstrable changes in the conduct of the surveillance process. There has been increased coverage of capital account issues, seeking to identify pressure points, and intensified probing of financial systems, particularly the soundness of banks. Given the Managing Director's well-publicised assessment that 130 members have suffered significant banking sector problems since 1980 and that the next major crisis will almost certainly start in the banking system or be intensified by its condition, it is recognised that Fund staff must concern themselves with the robustness of the financial system, including regulation and supervision, and potential monetary and fiscal pressures arising from banking failures. The promulgation in spring 1997 by the Basle Committee of its 'Core Principles for Effective Banking Supervision' and more active co-ordination with the World Bank will assist this work in future; the Fund now has yardsticks against which to monitor banking frameworks. It has also devoted more of its technical assistance to banking issues (as well as to statistics).

Another sensitivity is the exchange rate regime being followed by a country in potential difficulty. Exchange rate anchors have often been supported in Fund programmes as part of an anti-inflation stabilisation mechanism for open economies. But such anchors can be vulnerable and the consistency of other policies and market confidence must be continually reassessed.

The cost of the Fund's administration is, of course, a constraint on what it can do. It has therefore become important to release staff resources from elsewhere to bolster the surveillance process for countries at risk. Consideration has been given to less frequent, or less intensive, consultations for countries where policies seem sound and where contagion or systemic effects are unlikely. Selectivity in surveillance of topics and countries will be increasingly important. But delays to Article IV consultations will be avoided: the circumstances that can often encourage countries to try to postpone consultations—such as elections, formulation of programmes, uncertainties about policy and volatile markets—are precisely those in which policy can easily be blown off course.

When countries are in serious difficulties, the surveillance process may need to be enhanced further. The Fund has shown itself to be more flexible in this regard recently. Additional missions have been despatched to assess progress or provide technical advice. These have been supplemented by more frequent reports to the Board. Authorities have found such timely, independent assessments very useful, particularly when the case for a disciplined approach has been facing internal political problems. Visits and letters by Fund management to heads of state and government have reinforced the message.

The Fund always needs to be ahead of the game: to spot which countries are most likely to be heading for crisis, in time for them to implement corrective policies. To help this process it has been setting up new internal arrangements to identify and discuss countries where sharp shifts in market sentiment may occur. As well as looking in detail at warning indicators (such as the simultaneous evolution of rising real exchange rates, growing current account deficits, large portfolio inflows, vulnerable banks and declining output growth), some staff are detailed to keep in close touch with market analysts and other sources to supplement the continuous monitoring carried out by area departments. Assessments of such countries are regularly reviewed by Fund management, who are then in a position to notify the relevant authorities or the Board as they think appropriate. The Fund management has shown a willingness to offer explicit recommendations on policy corrections.

Regular discussions by the Fund Board on world economic and market developments can also reveal problems in specific countries. The purpose of such multilateral surveillance sessions is to review general developments in international capital markets such as changes in major exchange rates, bond yields and spreads, and the overall direction of economic growth and policy. These sessions have become increasingly market-focused to help to identify pressure points or the need for policy adjustment.

Speedy financial support

Surveillance is, however, not the whole story. The Fund is also expected to be ready to contribute financial support (often as part of a wider rescue package) if things go wrong. For most countries, there will be a lengthy period of negotiation with the Fund to ensure that domestic economic programmes justify Fund endorsement and support. But where access to international markets has been shown to be volatile and there is heavy pressure on the exchange rate because of uncertainty about policy, it may be necessary to speed up agreement considerably and front-load the finance. Sometimes delays in support can impose considerable costs on the subsequent programme and may undermine its realisation. This was the risk in the case of Mexico: there was concern that, though there had already been a fairly protracted period of negotiation, the failure to agree a large package of support from the US Congress could have precipitated a much deeper reaction in the absence of a swift agreement and announcement of the final IMF programme.

In September 1995 the Fund Board agreed a new set of procedures that would allow programmes to be agreed very quickly, but which nevertheless ensured that the Board—and therefore all member countries—was kept more closely in touch with developments and negotiations than it had been on Mexico. The 'Emergency Financing Mechanism' permits an agreement to be drawn up by Fund staff within five days and approved by the Board within two or three days thereafter. It was used for the first time by the Philippines in July 1997.

Adequacy of Fund resources

The size of the Mexican programme raised some concern about whether the Fund had sufficient resources to counter further turbulence. Although the Fund was able to support the Mexican programme without difficulty, because of the very high level of Fund liquidity at that time, projections suggested for a while that the burden of this and other large programmes (such as for Russia) could put strains on liquidity in the near future. This led Fund management to press hard for a substantial 'Quota Review' to provide additional resources.

The argument that the increased volume of private capital transactions requires larger Fund resources is by no means obvious. Most capital transactions take place between countries that are unlikely to require Fund resources: no industrial country has requested Fund assistance since 1984. It is clear that capital markets have been able to provide finance to industrial countries without undue problems. Though borrowing has sometimes proved expensive for countries in difficulty, there have been no problems about availability. It can also be expected that as more emerging markets mature, capital markets will be able to satisfy their needs for emergency, as well as regular, financing. The Fund will at most have a 'catalytic' role, providing guarantees about policy while markets provide most of the finance. So the implications for Fund resources could run in either direction.

Nevertheless, no one wants to take unreasonable risks. The Fund Executive Board is currently debating the eleventh

Quota Review, which is designed to ensure that the Fund has adequate liquid resources to meet expected demands. But the size of global flows means that there is always the possibility of a large surprise. Even if problems originate in a relatively small emerging market, there could be risks of contagion to neighbouring or similar countries, and even possible effects on the global payments system if a large number of markets are affected simultaneously. This could be a particularly serious concern if weak banking systems are involved. So it makes sense for the Fund itself to be able to borrow if such cases materialise.

The IMF has had emergency borrowing arrangements in place for some time. The General Arrangements to Borrow (GAB) were first agreed in 1962 and last amended in 1983, but have not been used since. The GAB, together with a companion agreement with the Saudi Arabia Monetary Authority, allow the Fund to borrow up to SDR 18.5 billion ($25 billion) if there are threats to the international financial system. Following the Mexican crisis, the eleven member countries of the G10, (who make up the GAB), agreed to try to double the resources available. In conjunction with Saudi Arabia and another 13 countries, (mainly emerging markets, smaller European economies and Australia), they developed the 'New Arrangements to Borrow', with similar provisions to the GAB. Together, the two arrangements allow the Fund to borrow a maximum of SDR 34 billion (about $46 billion). These would, if mobilised, allow the Fund to double the amount of its credit outstanding from its end-1996 level. The Fund is also permitted to borrow from other sources if necessary.

Other areas under considerations

The Fund is still considering action in two other areas:

(a) Burden-sharing with other creditors

The possibility that an international support operation can result in private creditors being bailed out was addressed in the report of a G10 working group in the spring of 1996 on the resolution of sovereign liquidity crises. It considered whether, in the event of a debt-servicing crisis, it might be possible to arrange an orderly standstill on debt payments. This would permit a debtor country to negotiate on equal terms with all its creditors, with the objective of finding a deal that reduced its obligations but was sufficiently generous to allow the country to emerge from the current crisis without putting off any future creditors.

Such an arrangement would necessitate mechanisms to involve all bond holders or their representatives. This led the working group to suggest that the terms of sovereign bonds might in future allow for the possibility of standstills, and recognise explicitly the agreement of creditors to allow others to negotiate on their behalf. There could be an impact on yields because the risk of default would be more explicit, but more realistic pricing of this risk would improve resource allocation and discourage poor policies.

The report raises a set of issues arising from such orderly workouts. The Fund has undertaken to look at whether, in certain circumstances, it might be able to provide credit to a country that has suspended payments to its bond holders.

(b) Capital account convertibility

The growth in international capital markets has been fostered in part by the dismantling of controls over private capital flows. The United Kingdom abolished such restrictions between 1979 and 1981. The European Union agreed to dismantle them in the run-up to EMU, and capital movements between industrial countries are now generally free of restrictions. This has encouraged a much more efficient distribution of capital, supplemented savings where domestic capacity is low, and greatly facilitated the flow of trade and investment.

The international community is now largely convinced of the benefits of free capital movements, though there is still concern in some countries about the vulnerability this can produce. The Fund has been promoting the virtues of capital account convertibility for a long time, in its advice to member countries. Nevertheless, the Fund's Articles of Association, reflecting the post-war regime of controls, only deal with capital account movements in the context of permitting restrictions—and even advocating them in some circumstances, such as the provision of Fund credit. This is an anomaly, and attention is now being given to amending the Fund's Articles to align them more closely with current circumstances and to give the Fund appropriate jurisdiction. The amendments presently being considered by the Fund Board would introduce a new objective for the Fund: the liberalisation of capital movements. The Fund would also have jurisdiction over some capital restrictions, though it is likely to be accepted that there may be a need to impose controls for prudential and security reasons, or to use temporary measures to correct payments imbalances.

Conclusions

The Fund has shown an impressive ability to adapt in its 53 years: after the collapse of the Bretton Woods fixed exchange rate system in the late 1960s; since the 1982 debt crisis; and with the economic transition of the centrally planned economies including the Soviet Union in the early 1990s.

Although the Mexican crisis of 1994/95 did not have the same direct repercussions on the world economy, the questions it raised for the Fund were fundamental. Had the Fund been doing a good enough job in surveillance, its primary area of activity? And could (and should) it provide massive financial support to large countries facing sudden capital outflows?

The response on surveillance clearly recognised that some of the Fund's procedures were inadequate. It was not looking critically enough at early warning indicators of financial crises and not focusing sufficiently on the capital account or financial sector weaknesses (primarily in banking). Moreover, its advice to member countries was couched in over-cautious language, and it had not attempted to deal with the markets' need for reliable, timely data and information about the Fund's assessments. It has now moved to remedy those deficiencies. Nevertheless, a number of issues remain. In particular, it is not clear that the right balance has yet been struck between preserving confidentiality and good relations with member countries, and providing clear and direct warnings to the markets.

On programmes, the international community has moved resolutely to ensure that the Fund can respond to emergencies. The Emergency Financing Mechanism now permits speedy and transparent procedures for Fund management and the Executive Board. The New Arrangements to Borrow, once ratified by the bulk of its participants, will supplement the resources that the Fund itself can mobilise. Meanwhile, though Fund liquidity remains fairly high, the Quota Review is considering whether further capital needs to be provided by member countries.

In providing for such resources, the international community is acknowledging that private markets cannot smoothly resolve all financing issues by themselves. But open capital markets are perceived to offer gains for all, and the Fund will almost certainly be called upon to promote full capital account convertibility.

The policies recommended to member countries by the Fund have been widely endorsed and encapsulated within the 'Partnership for Sustainable Global Growth'. Problems are increasingly attributed to a failure to implement these policies with sufficient rigour rather than to deficiencies in the policy design. The Fund has therefore chosen to reinforce rather than change the message.

The Fund's ability to prevent or mitigate the effects of international financial crises is limited to its persuasive powers and the leverage of the programmes it supports. It is now better equipped in both these areas. But innovation will continue to be necessary as markets develop, resources shift across the world and policy-makers reassess the choices facing them.