BANK OF ENGLAND

Speech

Reforming the International Financial System: The Middle Way

Speech given by

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1 Introduction

One of the roles which international financial officials are sometimes required to play is to describe disasters as triumphs and to make the dramatic seem bland. So, on 16 September 1992, following massive speculation against sterling and its suspension from the Exchange Rate Mechanism, the then Chancellor of the Exchequer, Norman Lamont, opened his statement with the words: "Today has been an extremely difficult and turbulent day". In the seven years since, several finance ministers have had cause to echo those words. Officials have spoken of the risks associated with capital flows. Well they might. Sharp reversals of capital flows to emerging markets have caused crises with a frequency and on a scale that threaten support for an open, market-led international economy.

These crises have created millions of victims, whose circumstances and aspirations were totally unrelated to financial markets. In Korea unemployment tripled, in Indonesia several years of economic growth were wiped out leading to political instability, and similar results have been visible in other parts of Asia as well as Latin America. Over the past century, governments in the industrialised world have, in the wake of domestic financial crises, taken steps to regulate and strengthen the financial system. Is there a similar need to change the rules of the game for the international financial system?

Capital markets do not operate on their own. They need an adequate legal and supporting infrastructure for participants to engage with each other. There is no magic wand that can be waved to create such an infrastructure internationally. Short of a world authority what is required is a patient process of building such an infrastructure. Some have described this as a need for new architecture; others as a need for plumbing. I prefer to speak of bricklaying. But after innumerable meetings of ministers and governors, deputies, deputies' deputies and so on, we still do not have an adequate building. Recent crises have shown that the need is not for a lavish palace but simply a roof over our heads. We need to get to the point where less time is spent on the role of the IMF in handling crises and more on the role of the World Bank in promoting development. So where should we start?

In order to answer that question it is necessary to understand the causes of recent crises. Without pretending to be comprehensive, I shall focus attention on the importance of balance sheets – national balance sheets – as the trigger for financial crises. I shall discuss four issues. First, I shall try to identify the problems underlying recent financial crises. Second, I shall discuss two fundamental or purist solutions which, although infeasible in the short run, do provide us with some ideas about how we might deal with these problems in our imperfect world. Third, I shall describe some practical steps – a "middle way" – to improve the international financial system. These are the bricks which are slowly being laid in place. Fourth, in the context of the middle way, I shall argue that transparency is of crucial importance. Notwithstanding the weaknesses in domestic policies pursued by a number of emerging market economies, there is a structural fault in the nature of international capital flows. Short-term debt flows, especially bank finance, are highly volatile. Unless that problem is tackled the potential for future crises will remain.

2 What is the source of the problems?

"Small open economies are like rowing boats on an open sea. One cannot predict when they might capsize."[1] So wrote Joseph Stiglitz, Chief Economist at the World Bank. He also likened the international financial system to a road which, after too many accidents, raises more doubts about the design of the road than the drivers involved. The analogy with travel has been taken up by Larry Summers, who compared global financial markets with jet aeroplanes. Travel is faster and, on the whole, safer. But crashes, when they do occur, are more spectacular. Whichever form of travel you prefer, one thing is clear. In recent years, the passengers have suffered from severe travel sickness. So much so, that their journey towards an open capital market has seemed, at times, a nightmare.

The core of the problems faced by a number of emerging markets has been the sharp reversal of capital flows. Between 1996 and 1998, the reversal of capital flows to the five Asian countries primarily affected (Korea, Thailand, Indonesia, Malaysia and the Philippines) was of the order of $125 billion, equivalent to 12% of the pre-crisis level of GDP. These reversals imply equal and opposite swings in the current account. To turn a large current account deficit into a substantial surplus within two years almost certainly requires a recession. In 1998 real GDP fell by 6% in Korea, by 9% in Thailand, by 14% in Indonesia, by 7% in Malaysia, and by 1% in the Philippines.

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[1] Stiglitz, J.E. *Financial Times*, 25 March 1998.

Moreover, the reversal of capital flows to emerging markets means that the industrialised countries must in aggregate run a larger trade deficit. The distribution of that increase in the collective deficit has already led to a debate about appropriate domestic policies in the G7, making it harder to resist the ever present protectionist pressures, especially in election years. So rapid reversals of capital flows bring substantial economic costs.

Capital flows also bring real economic benefits. They enable savings in one country to finance more profitable investment in another. That was a key feature of the world economy in the nineteenth century. Such flows also facilitate the transfer of knowledge and expertise. And by investing overseas, domestic residents are able to pool risks of various kinds with residents of other countries. To date, international diversification of portfolios has been remarkably limited. In particular, equity portfolios of investors in the industrialised world are heavily biased towards domestic equities. In part, this reflects the difficulty of obtaining adequate information about the legal, accounting and other aspects of the infrastructure of economies overseas. But the failure to exploit the full benefits of an open capital market reflects also the instabilities resulting from the volatility of short-term capital flows.

The volatility of capital flows has affected not only Asia but also Latin America, and almost all emerging markets have suffered directly or indirectly as spreads on their debt have risen to levels that in some cases have come close to cutting them off from the international capital market altogether. Indeed, Eisuke Sakakibara, formerly of MOF in Japan, has insisted that the past five years have been a "crisis of global capitalism"[2]. The so-called "Washington consensus" that sound macroeconomic and financial policies should embrace the free movement of capital has come under fire. Both Mexico and Korea, regarded as models of development to such an extent that they were admitted to the OECD, experienced damaging crises shortly after their elevation to the premier league of advanced economies. Contrast their fate with that of India. Capital controls insulated India to a large extent from the recent crisis. If we cannot find a way to reconcile free movement of capital with prevention of financial crises, then many countries may draw the lesson that they are better off with capital controls – either explicit or implicit – than without. Over the past decade, the two-year swing in the current account among G7 countries has been of the order of 1-2% of GDP. The largest swing was less than 4% (3.7% for Italy over the period 1992-94). These are small compared with the swing of 17% for Korea, in 1996-98.

[2] Sakakibara, E. (1999), "Reform of the International Financial System", speech to the Manila Framework Meeting in Melbourne on 26 March 1999.

Two dimensions of the reversal of capital flows have been evident in recent experience. First, their intensity and scale. Second, the rapid contagion from one emerging market to other previously unaffected countries. Both phenomena are a product of the nature of the capital flows concerned. The problems arise from short-term flows of debt finance, not long-term equity flows or direct investment.

Equity investment has a self-stabilising mechanism. When an investor wishes to withdraw from the equity market he or she has to find a buyer before they can head for the exit. The market price adjusts in order to attract a buyer to replace the seller. The physical investments financed by equity flows remain in place, even if their value on the market has fallen. The need to find a buyer to replace a seller can be expressed in the equivalent statement that the maturity of the liability is extremely long, in this case indefinite. The real problems stem from liabilities with very short maturities. These occur with debt finance, whether in terms of bank deposits payable on demand or longer-term debt finance which has almost run to maturity. In these cases, depositors who wish to withdraw their funds do not have to find replacement depositors. They simply take their funds out. The result is that, if this rush to the exit is on a sufficiently large scale, banks find themselves on the receiving end of a liquidity run. Such runs can occur even if the fundamentals are sound, although they are more likely when the fundamentals are weak. And the banking systems of some emerging markets compounded the problem by borrowing in foreign currency at short maturities and investing the proceeds in domestic currency assets at longer maturities. This was indeed a recipe for instability.

The importance of short-term debt finance in the reversal of capital flows in recent years is clear. Virtually the whole of the $125 billion reversal of flows to the five Asian crisis countries was accounted for by swings in short-term debt finance. And 80% of this swing resulted from changes in the net flow of finance from commercial banks. Figures from the Institute of International Finance suggest that the same picture is true for a larger group of emerging markets, with 81% of the decline in private net capital flows to the 29 most important emerging market economies accounted for by bank lending.

Liquidity runs, although not the sole cause of problems, did play a major part in recent financial crises. Such runs reflect mismatches in the national balance sheet. Such mismatches can occur in either the public or private sectors. An example of the former is Mexico in 1994, where short-term official dollar denominated debt exceeded foreign exchange reserves. Examples of the latter are

Thailand, Korea and Indonesia in 1997, where the private sector had borrowed short in order to lend long. Either maturity or currency mismatches create the potential for sudden reversals of capital flows on a huge scale. In the technical jargon, such markets are subject to multiple equilibria where a small event can cause a shift from one benign equilibrium state to another which is accompanied by rapid capital outflows. The possibility of a rapid shift from one equilibrium to another explains, in the words of Maurice Obstfeld, "why capital markets can appear to impose too little discipline before the crises arise, and too harsh a discipline afterwards"[3].

If this diagnosis is correct, two observations follow. First, capital flows in the form of foreign direct investment and portfolio equity investment should be encouraged. Emerging markets can do a great deal to increase these by adopting modern accounting standards, a transparent legal framework, and a stable market-friendly environment to which foreign investors will be prepared to commit long-term investments. Second, ways must be found to reduce the volatility of short-term flows of bank finance. The key is to avoid maturity and currency mismatches on the national balance sheet. That is easier said than done, and similar mismatches on the balance sheets of domestic financial institutions have caused financial collapses on a regular basis in the industrialised world.

Before turning to the question of how such mismatches might be limited if not prevented, let me mention two other contributory factors to recent crises. The first was overvalued real exchange rates, reflecting attempts to maintain fixed nominal exchange rates beyond their economic shelf life. Not only did such attempts contribute to a crisis when the nominal peg could no longer be sustained, but they also contributed to the illusion that it might be profitable to borrow at lower interest rates in foreign currency and invest at higher rates domestically, thus exacerbating the balance sheet mismatches. The second is that capital outflows do not result solely from the actions of overseas residents. Capital flight by domestic residents has been a factor in increasing the scale of outflows from a number of emerging markets. It is important to focus on the <u>nature</u> of capital flows not the <u>nationality</u> of investors concerned. Hence the resolution of crises involves more than simply restructuring liabilities to foreign banks or overseas investors. The problems created by the volatility of short-term debt flows require a structural solution.

3 Purist Solutions

[3] Obstfeld, M. (1998), "The Global Capital Market: Benefactor or Menace?", NBER Working Paper 6559, mimeo.

How can we design an appropriate infrastructure for the international capital market to prevent, or at least limit the frequency of, crises? To return to our transport analogy, there is clearly a case for eliminating blind spots on the road or lengthening the runway. But this is not enough. We also need to think about how the emergency services should respond to a crash.

The purist is led naturally to consider solutions of two opposite kinds. One, which maintains open and free capital movements, is to create an international lender of last resort (ILOLR). The second, at the opposite end of the spectrum, is to reinstate permanent capital controls.

Consider first the merits of an ILOLR. The obvious institution to play that role would be the IMF, and its First Deputy Managing Director, Stanley Fischer, provided a comprehensive cost-benefit analysis of an ILOLR earlier this year[4]. Although not new, the concept of an ILOLR has, in polite official circles, become the facility that dare not speak its name.

The principle of a lender of last resort was described by Thornton and Bagehot in the nineteenth century as a willingness to lend freely against good collateral at a penal rate. All three aspects of this principle – "lending freely", "good collateral", and a "penal rate", are problematic at the international level. An effective LOLR must be willing to lend whatever it takes to prevent a liquidity run. The more credible is the LOLR, the less the resources that are required to be lent in practice. Domestic LOLRs have credibility. But for a prospective ILOLR the decision for a group of countries, either jointly or via the IMF, to lend large sums to another country will always be difficult. In a world of nation states, it is unreasonable to suppose that political considerations will not enter the choice of recipient of such largesse. And the greater the political uncertainty about the willingness to act as an ILOLR, the larger the amount of funding that will be required. In turn, the operation will appear less credible, and the authorities are caught in a vicious circle. The current resources of the IMF - between \$125 billion and \$150 billion depending on how they are measured – are wholly inadequate for an ILOLR. Nor are resources on the appropriate scale likely to be forthcoming.

Moreover, serious moral hazard arises when the private sector ignores the risks of lending to a country because it believes that the country would be bailed out by the international community in the event of a liquidity crisis. And investors are encouraged to lend to emerging markets in forms – short-term debt – which are more likely to be bailed out. In the domestic context, the LOLR ensures that neither the managers nor the equity holders of the institution receiving support are allowed to benefit.

Internationally, it is not easy for the IMF to penalise those responsible for management of the economy, nor to distinguish between those citizens that have been responsible for excessive risk-taking and those who will be the innocent victims of the consequences of a financial crisis. It is the ordinary taxpayers in emerging market countries who will have to bear the burden of servicing loans from the IMF[5].

Absent a world government, it is difficult to see a credible ILOLR on the horizon. The basic reason is the maxim: "it's the politics, stupid".

The second purist solution, at the opposite end of the spectrum, is the imposition of permanent capital controls. In other words, a return to the world in which the Bretton Woods institutions were created half a century ago. The advantage of capital controls is that they prevent the liquidity runs that result from currency and maturity mismatch of the financial sector. India did not experience a financial crisis, Korea did. They also enable countries to maintain a fixed exchange rate while retaining some flexibility in domestic interest rates. And they might limit the movement of capital to lower taxed jurisdictions, thus slowing the inexorable decline of capital income taxation resulting from the development of a world capital market. But it is difficult to distinguish between controls on capital flows and flows related to trade. The growth of trade in services has highlighted the difficulty of separating currency trade-related flows from those representing investment. Thus, to be effective, capital controls are likely to impede trade flows. This would be a heavy price to pay and few countries have chosen to pay it.

Permanent capital controls have other disadvantages. They forsake all the economic benefits of a free capital market. And controls are never implemented by wise, or even merely clever, economists. They attract rent-seeking and corrupt behaviour in both official and private sectors. And they undermine the cause of market liberalisation. There is no shortage of protectionist tendencies that seek to limit trade and investment. We should not add to them.

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[4] Fischer, S. (1999) "On the Need for an International Lender of Last Resort", IMF.

[5] A point stressed by Calomiris ("The IMF's Imprudent Role as Lender of Last Resort", Cato Journal, Vol 17 No. 3 1998) although he underestimates, in my view, the possibility of liquidity runs as seen, for example, in Korea in 1997.

So neither purist solution is likely to appeal - the one because there is insufficient political and financial support for an ILOLR, and the other because permanent controls go against the grain of promoting market reforms and good governance.

But the present system is not sustainable. The danger is that we have the worst of both worlds. The IMF may lend large amounts, create moral hazard in doing so, and still not be able to ward off the threat of financial crises. And faced with a run on their currency or banking system, countries may be forced to take unilateral action to suspend payments. So what to do?

4 The Middle Way

Given that neither purist approach is on the agenda, the international community has been trying to take some practical steps forward. The aim is to reduce the frequency and severity of financial crises. Some might describe this as muddling through. I prefer to call it the "middle way". The difference is that the middle way is based on the principle that if the emergency services will be slow to arrive then whichever form of transport you care to think of, borrowing countries should drive slowly.

How to encourage and enforce careful driving has been the subject of innumerable international meetings. Initially, the discussion took place in the G10, which, as you know, comprises eleven countries. Then last year the discussion was taken up by the G22. By the spring of this year that group had become the G33. Can you complete the sequence by guessing which international forum will take the lead next year? Suffice it to say that at the original Bretton Woods conference there were forty-four countries and it took place fifty-five years ago.

In terms of practical steps forward, it is useful to distinguish between the **prevention** and **resolution** of crises. On the former, recent experience suggests five lessons for emerging markets:

(1) Create a do it yourself (DIY) LOLR, with the aim of providing self-insurance against a liquidity crisis. There are several ways of providing such insurance. One is simply to build up large foreign currency reserves. This has already been taken to heart by emerging markets. China has substantial foreign exchange reserves ($147 billion at the end of June). And Korea, perhaps the best example of a country suffering a liquidity run on its banking system in terms of foreign currency, has raised its reserves from a low point of $7.3 billion in November 1997 to a current high of $64.8 billion in August. It is unfortunate that the absence of more efficient solutions to the risk of crises means that scarce capital might be deployed in this inefficient way. Building up net reserves – via current account

surpluses - will reduce world demand at a time when the US economy is unlikely to provide as large a stimulus as over the past five years. An alternative is to create gross reserves by borrowing from abroad and investing the proceeds in liquid international securities. Both methods involve costs. A second approach to DIY LOLR is for emerging markets to create contingent credit facilities with international banks, as Argentina has done with its contingent repo facility, or try to set up collateralised loan facilities along the lines suggested by Martin Feldstein.[4] A final approach to the DIY LOLR, in the absence of an effective multilateral ILOLR, is the creation of regional self-insurance funds. All of these approaches are likely to be pursued, to a greater or lesser extent, in the wake of recent financial crises.

(2) Manage the national balance sheet, and, as far as possible, avoid maturity and currency mismatches. For a country without a track record of international borrowing, it is important to manage its external liquidity position, especially in foreign currency. The lack of foreign exchange controls means that it will be difficult to observe, let along manage, the balance sheet of the entire private sector. But the key elements are those relating to the public and banking sectors. Governments already have information on these sectors. As important as anything is the need for self-awareness by the countries concerned of the state of their national balance sheet and the approach of impending liquidity difficulties. When governments and markets alike are informed of the potential for future financing difficulties, both sides have time to take preventive action. Of course, the use of derivative instruments and hedging techniques makes the assessment of risk exposure more difficult. But the effort must be made. Alan Greenspan has suggested that consideration be given to simple rules of thumb such as that countries without a track record of international borrowing should maintain unencumbered foreign exchange reserves sufficient to meet all foreign currency liabilities over the following year, and that the average maturity of external liabilities should exceed three years. Rudiger Dornbusch has proposed the use of value at risk assessments of country balance sheets. Ideas such as these, precisely because they focus on the national balance sheet, are sure to be centre stage.

(3) Encourage inflows of equity rather than debt finance. This is an extension of the need to manage the national balance sheet. The imperative is the old adage: borrow long not short. A credible legal and institutional infrastructure for private investors would go a long way to encourage equity inflows. Reserve requirements on short-term debt inflows, as adopted in Chile, might help to modify the pace of vulnerable capital inflows, but will, in themselves, do little to help in times of rapid capital outflow. It is also time to reconsider the incentive to the provision of short-term finance provided by the Basel Accord risk weights.

[4] Feldstein, M. (1999), "A self-help guide for emerging markets", **Foreign Affairs,** March/April, 93-109.

(4) Promote the better design of debt contracts which provide a framework for negotiation between creditors and debtors when financing difficulties arise. The particular proposal - advanced initially by a G10 Deputies' report in 1996 and subsequently endorsed by the G7 - for the use of collective action clauses in sovereign debt contracts has attracted interest. How far such clauses would help is unclear. Bonds issued under UK, but not US, law – currentlythese account for just under 50% of the stock of emerging market eurobonds – generally include such clauses already. But their widespread adoption looks unlikely, not least because of the reluctance of the G7 to incorporate such clauses into their own debt contracts. More productive in the short run is likely to be the promotion of regular contacts between debtor countries and their creditors in good times, well before any crisis occurs. State-contingent debt where returns are related to the price of major exports is another possibility.

(5) Avoid, at all costs, the defence of fixed but adjustable exchange rate pegs when they are no longer consistent with internal and external equilibrium. Thailand shows the cost of a prolonged and ultimately unsuccessful attempt to defend its exchange rate. Brazil shows that there is life after a fixed exchange rate. It is much too early to conclude that emerging markets have little option but to adopt the dollar as their currency.

To these five imperatives, I have refrained from adding the mantra of better banking supervision. Of course, banking supervision should always strive to be better. But is it not time to ask the question of whether the implicit government guarantee afforded to the banking systems of the major industrialised countries is itself not part of the problem. One of the factors contributing to the scale of short-term debt flows to emerging markets is the moral hazard implied by the financing of banks in the developed world. It is certainly crucial that international rescue packages do not lead to moral hazard in the provision of finance to emerging markets. But an important lesson for the G7 is that moral hazard starts at home.

In the <u>resolution</u> of crises less progress has been made. The IMF can, and has, provided financial assistance without which the cost of recent crises to the affected countries would have been even greater. But the stumbling block has been how "to involve the private sector". Although the statement by G7 finance ministers to the Cologne Summit in June set out both "principles" and "tools" for involving the private sector in crisis resolution, much remains obscure. Unilateral debt moratoria can be damaging in terms of future access to capital flows. But there will be circumstances in which a debtor country and its creditors could benefit from a joint resolution of temporary payments difficulties, and procedures are needed to prevent some creditors from free-riding on others. The following four elements in crisis resolution merit some consideration. They have no particular status, but are issues that need to be faced. The four are:

(i) the provision of official finance should be linked to the involvement of other creditors, including the private sector, in the resolution of crises. This can be achieved by the IMF setting a floor for the minimum level of foreign exchange reserves a country is required to maintain;

(ii) the aim of resolution is to find a co-operative solution negotiated between a debtor and its creditors. No particular class of creditor should be in a privileged position, unless the instrument in question explicitly gives it preferred creditor status;

(iii) the use of temporary standstills – possibly sanctioned by the international community - would allow time for a country to negotiate with its creditors. In the absence of a formal mechanism to achieve this, the IMF can indicate its endorsement of a standstill by being prepared to provide new money to a country which has temporarily suspended payments to its creditors (often referred to as IMF lending into arrears). By making standstills part of the furniture – or one of the bricks – they would be seen not as an ad hoc response, which might lead to contagion in other emerging markets, but part of an approved process;

(iv) measures, including perhaps strictly temporary capital controls, to prevent capital flight by domestic residents in exceptional circumstances. It would be odd to sanction a standstill of payments to foreign creditors while allowing domestic residents to move assets overseas without restriction.

The essence of the middle way is to find practical steps forward to enable emerging markets better to manage the liquidity positions of their external liabilities, and to reduce their dependence on debt finance. Crises will still occur. But the aim is to reduce their frequency and severity. To that end there is one further policy which is fundamental to the success of the middle way - transparency.

5 Transparency

Transparency is one of the most popular words in economic policy today. Much has been said about transparency, and, interestingly, much has been done. Why is transparency so important? In itself, transparency will neither prevent nor resolve financial crises. But transparency can help reduce the frequency of crises – by alerting not only markets but also policymakers to problems on the horizon –

and their severity – by minimising the surprises about the scale of any liquidity problems. In Korea, the foreign currency exposure of its banking system was not known until after the crisis had hit. And in Thailand, the true state of the foreign exchange reserves was unknown even to its own finance ministry, let alone financial markets. So transparency can be seen as a "second best" policy when purist solutions to financial crises are unavailable. It is in the context of the middle way that transparency comes into its own.

The aims of transparency are to allow better informed decisions in both public and private sectors, to reduce the risk of contagion by allowing markets to differentiate among borrowers, and to encourage macroeconomic policy to become more predictable. Transparency is not simply a question of making available certain data. It is an approach to economic policy, almost a way of life. The G22 Report of the Working Group on Transparency and Accountability (which I was privileged to co-chair with Andrew Sheng of the Hong Kong Monetary Authority) was published in October 1998. Its recommendations were endorsed in full by the G7. It stressed the importance of transparency in three different sectors: national governments, the private sector, and the international financial institutions. Good progress has been made in implementing many of its recommendations.

Rather than give an exhaustive account of progress in transparency, let me give a few examples. In March of this year, the IMF's Special Data Dissemination Standard was strengthened by the inclusion of a template covering the disclosure of net foreign exchange reserves and short-term foreign currency liabilities of central government. These data are required to be published monthly with a lag of no more than one month, and the transitional period for observing the standard runs to the end of March 2000. Agreement is close on a Code of Monetary Policy Transparency to match the earlier Code on Fiscal Policy Transparency.

BIS data on international banking statistics will be produced quarterly from next spring, and the lag in publication shortened. One of the three Financial Stability Forum Working Groups is considering the quality and timeliness of disclosure of exposures to and of highly leveraged institutions. This category includes hedge funds. Proposals for direct regulation of internationally mobile funds are unlikely to be workable. But many commentators remain suspicious, regarding such funds as like children playing just out of sight who are told – "I don't know what you're doing, but, whatever it is, stop it".

The IMF itself has become more open about the release of information. During an eighteen month experiment countries will be able to publish their Article IV reports. And more background information, including policy papers and programme reviews, is now available. All this should improve the transparency and accountability of national governments, the private sector, and the IMF.

But there is one further step on which progress is urgently required. In a world of sovereign states, countries cannot, and should not, be compelled to disclose information if they do not wish to do so. But countries should not be able to claim to be transparent when in fact they are not. A crucial substitute for the inability to make transparency mandatory is that we need transparency about transparency. That is why the G22 Report recommended that the IMF – in the context of its Article IV consultations – prepare a Transparency Report for each country summarising the degree to which that economy complied with disclosure standards and codes of conduct. The case for "transparency about transparency" is the case for honesty in economic policy.

Some progress has been made. Pilot transparency reports on the UK and Argentina have been produced by IMF staff. Other pilot reports are to come. Australia has published a self-assessment transparency report. The need now is to make the production of Transparency Reports an integral part of the Article IV process. There is no reason for further delay. Transparency Reports should always be published. I very much hope that the IMF will make rapid progress towards the regular production and publication of Transparency Reports on each country. This practical measure could do a great deal to enhance the performance of all economic actors involved in the international capital market.

6 Conclusions

Unrestricted capital mobility and the absence of an ILOLR are not a recipe for a stable international financial system. Short-term interbank flows are the Achilles heel of present arrangements, leading to both currency and maturity mismatches. Throw in a predilection of emerging markets for pegged exchange rates and you have a dangerous cocktail. Purist solutions - whether of an ILOLR or a return to permanent capital controls – are, for good reasons, unlikely to be pursued. What is needed now are some practical steps forward. Central to any such programme is the need to monitor and manage the national balance sheet. The objective cannot be to eliminate the risk of financial crises. The middle way will not do that. But it can reduce the frequency and severity of crises. In this context transparency is important. There will still be crises in the future, but transparency will reduce their costs and help to keep governments closer to the straight and narrow. All central bankers will surely welcome that.

Of course, the immediate crisis has receded, and some of the Asian countries, in particular, have recovered sharply over the past year. But we should not be misled by the calm after the storm. There will be future storms, and now is the time to prepare for them. There is no need for another international conference of the kind which led to the creation of the Bretton Woods institutions. But there remains a need for thinking as original and imaginative as that which inspired the Bretton Woods conference. The middle way is a start, but no more.

David Ignatius has written about the "founding generation", people such as Dean Acheson and George C. Marshall, who created the great post-war institutions. All of those institutions have now passed their fiftieth birthday. It is time to appraise carefully the architecture, foundations, plumbing and even bricklaying of that inheritance. Ignatius described the qualities of the founding generation as "resolve and clarity". Those qualities are still required. Dean Acheson entitled his memoirs, "Present at the Creation". Let us hope that, similarly, a new generation of officials will be able, at some future date, to look back at the creation of an open world economy in which financial crises were successfully contained. That would be an achievement of which all economic bricklayers could be proud.