



Current Issues in Emerging Market Economies

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Broad in Scope, Soft in Method.

International Cooperation

and the Quest for Financial Stability

in Emerging Markets

Preliminary.
Comments welcome.

**BROAD IN SCOPE, SOFT IN METHOD.
INTERNATIONAL COOPERATION AND THE QUEST FOR FINANCIAL STABILITY
IN EMERGING MARKETS**

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“Commerce and Manufactures can seldom flourish long in a state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. [...] In short, if there is not a certain degree of confidence in the justice of government.”

Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book V, Chapter III, 1776.

“In this world, the optimists have it, not because they are always right, but because they are positive. Even when wrong, they are positive, and that is the way of achievement, correction, improvement, and success. Educated, eyes-open optimism pays; pessimism can only offer the empty consolation of being right”.

David Landes, *The Wealth and Poverty of Nations*, Abacus, London, 1998.

1. Introduction¹

In a major departure from previous practice, ever since the outbreak of the Asian crises promoting sound and effective financial regulation worldwide, and in particular in emerging markets, has moved to the top of the agenda of international economic cooperation. Until then, the prevailing doctrine was that designing and managing the safety net surrounding the financial system was an exclusive prerogative of the nation state. Indeed, preserving national financial systems from the vagaries of capital flows can be counted as one of the main, if only implicit, objectives of the Bretton Woods regime - despite all its shortcomings still the most successful instance of international monetary cooperation ever.

The strategy the international community has developed to meet the new challenge hinges on two features. First, a predominant emphasis on banking, as opposed to other forms of financial activity. Second, heavy reliance on what has been labeled “soft law”, namely standards of good practice and codes of conduct endorsed at the international level but which lack legal standing, so that their implementation in the various countries is essentially left to the discretion of national authorities. The first feature is hardly surprising. Banks still account for a disproportionate share of emerging markets’ financial system, and will continue to do so for the foreseeable future (Goldstein, 1996). The second is instead more controversial. If countries have proved unwilling or unable to strengthen their financial systems so far, why should they now voluntarily adopt standards and codes that lack any legal (i.e. externally enforced) authority? Does it not a plea for spontaneous collaboration on the part of national authorities after an unprecedented spate of banking crises amount to a confession of impotence, or at least of a lack of political determination?

Along these lines, a number of critics of the soft law approach have advocated some form of centralization of the regulatory process in an institution endowed with enforcement powers (Eatwell and Taylor, 2000; Soros, 2000). In the same vein, although falling short of suggesting centralization of supervisory power, the influential US Meltzer Commission has argued in its report that a policy of tying IMF lending to a limited set of structural pre-conditions, most notably capitalization rules, would be preferable to the time consuming and dubiously effective soft law approach.

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The complexity of reaching a binding agreement in a world comprising almost 200 independent nations has clearly been an important factor in the sluggish progress of the debate on international financial architecture. A corollary of this statement, however, is that it would be easy to dismiss reform plans hinging on centralization of authority as politically naive in the present context. But doing so would beg the interesting analytical question, namely: would centralization of the regulatory and supervisory authority be the best response to the resurgence of financial instability worldwide?

The thesis I will develop in this paper is that it would not. The argument has three components, which run respectively at a practical, analytical, and historical level. The practical component is that the art of financial regulation and supervision is presently in the middle of its biggest upheaval since the 1930s. The widespread involvement of banks in the business of derivatives, the rapidity with which financial markets react to news, and the emergence of global financial conglomerates is pushing regulators towards greater reliance on internal credit risk assessment by banks and other forms of "market-friendly" regulation - as witnesses the revised Basel Capital Accord. But these new tools are far from being fully tested. Indeed, reliance on the market's own risk assessment may have the effect of exacerbating the procyclicality of capital requirements. It is to avert this risk that the New Capital Accord places particular emphasis on the "Second Pillar" of the new approach, reliance on supervisors judgement and alertness (White, 2000). The view that capital requirements might usefully be supplemented with subordinated debt rules is also gaining popularity (Evanoff and Wall, 2000). Thus, this seems the worst of times to offer emerging markets a simplified and necessarily rigid set of rules as an "ideal" model around which to shape domestic regulation and supervision.

The analytical component instead runs as follows. Because of asymmetric information problems and the very nature of financial claims, whose function is to transport into the present intrinsically uncertain cash flow streams, financial markets cannot manage themselves. They need what Olson (2000) has called *market-augmenting government*, namely "a government powerful enough to create and protect private property rights and to enforce contracts, yet constrained so as not to, by its own actions, deprive individuals of the same rights". Not all government intervention is market-augmenting, of course. But surely any form of market-augmenting government, to be truly so, must be firmly "embedded" in the country's institutional environment, so as to draw from it at once legitimacy and flexibility. Mediocre regulation consistently designed and credibly enforced is better than an ideal regulatory system arbitrarily applied. Take the example of capital regulation: no matter how precisely one measures "capital", the true net worth of a bank depends on the quality of its portfolio, which, however, for many banks is still dominated by difficult to evaluate loans. In emerging markets, this problem tends to be exacerbated by volatile prices and thin markets. As a result, both bank managers and regulators are bound to enjoy considerable discretion in gauging when a bank is truly insolvent. The same could be said of loan provisioning practices. Moreover, one could hope that an independent regulatory agency will discharge its task responsibly, but this will be hard to come about if the environment within which the agency operates comprises poorly paid supervisors, or laws stipulating that supervisors themselves can be sued for their actions and be held personally liable - as is presently the case in several emerging market countries (World Bank, 2001).

This view - whose roots, as one of the epigraphs to this essay testifies, can be traced back to Adam Smith - is supported by a promising new strand of empirical research, which shows that the quality of the legal and institutional apparatus *does* have a significant impact on economic and financial development. Hall and Jones (1999), for example, show for a sample of 127 countries that an index of social infrastructure can explain up to two thirds of the otherwise unexplained cross-

country differences in labor productivity. In the same vein, La Porta *et al.* (1999) find that the degree of protection of investor rights is an important determinant of a country's level of financial deepening.

The acid test of market-augmenting government is a financial crisis. Technically a crisis is a situation in which time is scarce and the pay-offs associated with alternative courses of action unclear. This is why it is so difficult to set up clear-cut rules to be adhered to under stress condition. In principle, if information were complete, contracts were perfectly enforceable and negotiating costs were negligible, there would be no need for a crisis management mechanism. But these conditions are unrealistic, and real world contracts always turn out to be fundamentally incomplete. All one can aim for in these conditions is to specify procedural rules to be activated in case one of the parties, for whatever reason, failed to honor its commitment. This is for instance what bankruptcy systems try to achieve. If a firm defaults, bankruptcy law will be invoked, but this in no way assures creditors that they will recover the full value of their claims; quite the contrary, bankruptcy law in many countries contains a bias in favor of the distressed firm. An efficient bankruptcy law is simply a body of law specifying credible procedures for carrying out this task equitably and without pre-judging the incentives of creditors to invest in the first place. In some cases, crisis management aims at the more ambitious goal of reducing recourse to outright default of individual firms or large sectors of a given industry, and this may only mean that it aims at suspending the rights of one or more sets of parties in order to achieve a solution that is socially superior to what would happen otherwise. Crisis management, in other words, consists in supplementing privately agreed contracts with derogations, exceptions, and sanctions administered having the social welfare in mind.

Once this is recognized, it becomes clear why crisis management has always been considered a prerogative of the nation state. It becomes also clear, however, why circumscribing the discretion of the executive power as crisis manager is so important and so difficult at the same time. Modifications of contracts that are efficient *ex post* may lead to outcomes that are inefficient *ex ante*. Procedural rules are but a means to induce the crisis manager to strike a socially acceptable balance between *ex post* and *ex ante* efficiency. But such rules will be credible only to the extent the crisis manager itself is held accountable for its behavior. Hence the need for "embeddedness" of the safety-net in the national legal and political apparatus.

Finally, the historical component purports to show that the search for effective crisis management tools, triggered by the failure of the simple but also rather mechanical rules that had previously guided central bank actions, has been absolutely central in the evolution of financial regulation in the industrial world during the last century. The development of crisis prevention tools was in many cases but a by-product of this process, motivated either by the desire to internalize the costs of the safety net established for crisis management purposes, or by the need to circumscribe as much as possible having to deal with crises in an under-institutionalized environment. Within this framework, international cooperation has gradually increased in importance. It was virtually non-existent before World War II. It then assumed an implicit yet important role in the Bretton Woods years, since that regime was predicated on the assumption that states would coordinate in heavily regulating their own financial systems, to curb capital mobility and reduce spill-over effects. It finally became explicit and crucial in the process of developing the prudential restrictions needed to make constructive ambiguity – the regulatory regime that replaced financial repression after the demise of the Bretton Woods apparatus – both operational and credible. My contention is that emerging markets are going through the same experience industrial countries underwent in the 1930s. They have liberalized their financial systems without paying sufficient attention to the demands market-led finance poses from a regulatory perspective. The recent wave of banking crises is to a large extent the outcome of a failure of market-augmenting

government (Honohan, 2000; World Bank, 2001). This being so, it would be unwise to disregard the lessons history has taught authorities in industrial countries. Among them, that short-cuts, no matter how appealing they might look in the short-run, are unlikely to secure lasting financial stability.

This is not meant to say that the soft law strategy, as it now stands, is fully satisfactory. I will indeed argue that there are at least three areas – access of foreign institutions, the area of crisis management itself, and the formal recognition of the benefits of capital account liberalization – where bolder steps are needed. But I think that working at refining the strategy in these areas holds greater promise than either of the alternatives that have been proposed so far.

The paper is structured as follows. Section 2 reviews the history of financial regulation and supervision in the developed world. In Section 3 I discuss at greater length the soft law and the centralization strategies against the background of that history. Section 4 isolates the three main missing elements in the current version of the soft law strategy. Section 5 concludes.

2. The History of Financial Regulation in the 20th Century: an Interpretation

The history of financial regulation remains to be written. While a number of histories of banking and finance have appeared in the course of the last two decades, and several shorter essays have focused on the origins of this or that aspect of the present regulatory set-up, no systematic effort has to date been undertaken to trace the economic rationale, political background, and actual impact of the vast number of policy initiatives taken over the last century and a half to ensure financial stability.

It is clearly beyond this paper's scope and ambitions to try to fill this gap, remarkable from many standpoints. But I think that the need to put financial regulation "in perspective" has never been as acute as it is today. While the world is embarking upon the first attempt to put together a coordinated strategy towards financial stability, one simply cannot avoid trying to sketch an interpretation of how we arrived at where we are today, and why such a coordinated effort has had to wait so long before taking shape.

My purpose in this Section is to show that financial regulation emerged in the first decades of the twentieth century from frustration with the rather mechanistic techniques that had been developed in the second part of the previous century for managing money both in ordinary and extraordinary circumstances. Sustaining confidence in both money and the banking system proved a much tougher task than had previously been envisaged. The need to ensure at once the legitimacy and the effectiveness of the new techniques, which in contrast to previous ones entailed a large degree of discretion, accounts for the deep and comprehensive institutional reform process of the 1930s, and in particular the adoption of special banking legislation and the redefinition of the tasks, legal status and operational independence of central banks. It is ultimately responsible for the doctrine that pursuing financial stability falls within the area of responsibility of the nation state, and cannot be delegated to supranational bodies. Regulatory embeddedness, as this doctrine may be called, did not imply banking autarky. The latter was, however, an implicit pillar of the Bretton Woods regime, which may be construed as a conscious attempt to reduce the need for international cooperation in the financial sphere by reducing the degree of integration of national financial markets, and hence the potential spill-over effects of instability. Over time, the attempt to direct the banking system towards social priorities resulted in outright banking *dirigisme*. The natural erosion of controls as market players tried to circumvent them, technological innovation, growing dissatisfaction with the social costs of dirigistic policies, and a number of specific crisis episodes,

from the early 1970s on, exposed the drawbacks of the extant institutional environment. This led regulators in the industrial world to seek ways first to liberalize their financial systems in a coordinated fashion, and then to define common standards for good supervision. Although informal and little publicized, international cooperation is in the end responsible for all the main changes occurred in financial regulation over the last two decades.

2.1 Inter-war Bank Instability and Regulatory Embeddedness

Although the first comprehensive attempt to regulate the banking system may be traced back to the Swedish banking act of 1846, it can be safely argued that financial regulation is a twentieth century phenomenon. It is to the events of the years from 1930 to 1933, in particular, that we owe the regulatory apparatus still existing, though in a much modified version, in our days. Up to then, specific banking codes, far less extensive than what we have today, had been introduced, apart from Sweden. only in the United States (1863) and Canada (1871).

The timing of the generalized regulatory wave is rather puzzling, since banking had reached a fairly advanced level of development in numerous countries already in the second half of the nineteenth century, and episodes of banking instability were, over the same period, fairly abundant and diffused (Cameron, 1967). The main reason that held financial regulation in check was the widespread belief that an effective monetary anchor, or monetary standard as it was called at the time, would ensure at once monetary and financial stability. Behind this belief, there lay the assumption that bank deposits were just a substitute for gold coins and banknotes, not an alternative form of money. Since it is the aggregate supply of money that determines the price level, once that magnitude is brought under control, by whatever means, financial instability becomes either impossible or irrelevant. In our time, this proposition has been restated under the form of the Schwartz Hypothesis, according to which price stability is both a necessary and sufficient condition for financial stability.²

For all their differences, the Currency and the Banking Schools did share this view. They disputed over the best way to attain monetary stability, and in particular on the relative merits of direct limits to the supply of banknotes as opposed to gold convertibility, rather than on whether alternative (or additional) goals had to be pursued. As a consequence, they both played down the importance of controls on the process of credit creation. The institutional set-ups in England and in the United States until the Great Depression can be taken as epitomes of both the differences and the similarities of the two schools' prescriptions in this regard (Kregel, 1998). In England, the Peel Act of 1844 espoused the currency principle. Accordingly, strict limits on the supply of banknotes were established. Soon, it became clear that some flexibility had to be allowed to deal with temporary monetary disturbances, and this took the form of the Bagehot Rule, which provided for temporary departures from profit seeking on the part of the central bank. It is to be noted that at no point Bagehot suggested that the central bank should care for the stability of individual institutions, as witnesses the proposition that central bank advances should be fully collateralized and provided, in crisis situations, at a penalty rate. Thus, as two modern commentators have argued, the Bagehot rule should be regarded as complementary to the currency principle, and not in contrast with it (Humphrey and Keleher, 1984). They were in essence both rules of thumb, supposed to guide action respectively under ordinary and extraordinary circumstances. On the other side of the Atlantic, the Federal Reserve System was explicitly shaped, in 1914, after the Banking Principle, as embodied in the real bills doctrine. To "furnish an elastic currency", as the new act dictated, the Fed was supposed to create notes backed by self-liquidating short-term commercial lending. Under both systems, financial regulation and supervision were redundant, as long as the respective central banks stuck to the rules of the game.

² The hypothesis in this form is stated in Schwartz (1995).

The events of the first three decades of the twentieth century had overall the effect of sweeping away both systems of monetary control. Starting with the crisis of 1907 (and possibly even earlier on, with that of 1893), to end with the Great Depression, major episodes of financial instability emerged which could not easily be faulted on either price instability or excessive money creation.³ Meanwhile, the methods of monetary control that had taken shape after the Currency and Banking School both started to show their flaws in the presence of a well-developed financial system. During the war of 1914-1918 and immediately after, for example, the prevailing, abnormal conditions compelled most central banks to relinquish some of the restrictions on rediscounting and to widen the basis of rediscounts as well as of collateral loans. Where needed, their statutes were amended to make this possible (De Kock, 1974, p.89). The Great Depression, on its part, exposed the flaws both of penalty-rate lending, which if anything risked making matters worse for ailing banks, and of the real bills doctrine.⁴ Indeed, the Fed found itself crippled in its ability to inject liquidity into the system by the fact that, due to the expansion of long-term investment finance in the boom of the 1920s, US banks had run short of those short-term assets eligible for rediscount. As documented in Allen *et al* (1938), that experience was by no means restricted to the United States.

Overall, these events brought about a true intellectual revolution. The chequeable bank deposit ceased to be regarded as a simple money-substitute, being instead recognized as an innovative payment technology, whose disruption would bring about unacceptable social externalities (Giannini, 1995). Commercial banks were as a consequence seen as "special", since, even if deprived of note issuing faculties, by now concentrated in central banks, they were capable of multiplying money *ex nihilo*, through the process of credit creation. Accordingly, they required special "care", independently of what went on in other parts of the monetary system. This state of affairs posed a challenge for both monetary and crisis management, because it meant that traditional rules of thumb could no longer be expected to work. The ultimate result was:

"the great mass of legislation, often extremely detailed and technical in character, designed to regulate and control the institutions to which the people's money has been entrusted" (Allen *et al*, 1938, p. 7).

Bringing banks under the reach of central banks for monetary management purposes was a relatively straightforward task. Prior to the 1920s, no specific reference had been made in central bank statutes to the control of credit. This could easily be amended. During the late twenties, the statutes of certain new central banks established under the influence of the League of Nations stipulated that they were to "exercise control over currency and credit" (Greece) or "regulate the money circulation and credit" (Poland) or "provide for the monetary circulation and the control of credit" (Romania). In time, bigger countries would follow. Thus, the central bank of Canada was mandated in 1934 "to regulate credit and currency", that of India in 1935 "to operate the currency and credit system of the country to its advantage", the Bundesbank in 1957 "to regulate the money circulation and the supply of credit to the economy", and so on. The new mandate was carried out not only through interest-rate policy, but also through several brand-new tools: open-market operations, reserve requirements, moral suasion, and direct credit controls.

Establishing an effective crisis management apparatus, by contrast, was a trickier matter, because the danger of moral hazard was well recognized. Remember that the demise of both the Bagehot Rule and the Real Bills doctrine left the central bank with no clear-cut rule on which to

³ See Bordo and Wheelock (1998) for a discussion of the evidence.

⁴ As Ragnar Nurkse later remarked in a highly influential report: "when flight psychology prevails no increase in the discount rate may be sufficient to deter it. Indeed an increase in the discount rate, by shaking confidence further, is apt to produce the opposite effect" (Nurkse, 1944, pp. 162-163).

base its liquidity support policies. Moreover, recognition of banks' specialness entailed that it could be socially desirable to rescue, or at least to liquidate in an ordinary manner, also patently insolvent banks - something both Bagehot and Banking School's theorists considered anathema. Not surprisingly, in setting about the new task, countries were heavily influenced by local legal and institutional traditions, or what neo-institutionalists of our days would call the "institutional environment".

There were three sets of decisions to be made, concerning respectively method, control, and substance. As to the method, in principle the legislator had to choose between three options. First, he could insert special provisions for banks in the general acts. This route was taken by the United Kingdom with the Companies Act of 1929. Or he could take all rules applying to banks and collect them in a special banking law. This route, particularly suitable for countries with a diverse banking system, was followed, for example, by Denmark in 1930, Switzerland in 1934, and Italy in 1936. The third, suitable for countries where banks are relatively homogeneous but the financial system comprises also other institutions, consisted in introducing a law covering all forms of financial intermediation, as in the Swedish Bank Act of 1911. Control structures ranged from the institution of Bank Inspectorates, a system in which control is exercised directly by the state, so that formally neither the central bank nor the commercial banks have any voice in it, to the delegation of control to the central bank, with a mid-way solution consisting in the establishment of banking commissions, members of which would be drawn from both political and technical institutions.

But it was in matters of substance that the most far-reaching innovations were made. The main lesson authorities worldwide drew from the financial turbulence of the inter-war period was that competition in banking could easily become excessive. A number of "structural" controls aimed at curbing competition were then introduced, such as: restrictions to entry and branching; mandatory specialization of activities, as in the United States with the Glass-Steagall Act or in Italy with the Banking Law of 1936; the imposition of ceilings on deposit interest rates; nationalization of distressed banks. The latter meant, in countries like Italy and France, nationalizing the bulk of the banking system.

Structural controls were not the whole story, even though at the time and for many years after they attracted most of the attention. Two other far-reaching substantive innovations were introduced in those years – which moreover are still with us, while structural controls are long gone. They are special bankruptcy procedures for banks and bank supervision.

Bankruptcy procedures, whose rationale is ultimately to be found in the fundamental incompleteness of contracts, have two basic objectives (Hart, 1998): to maximize the value of the insolvent entity (ex post efficiency); to allocate losses in an equitable and predictable way, so as not to discourage efficient risk taking (ex ante efficiency). Until the 1930s, bankruptcy procedures applied indifferently to financial and non-financial companies. The legislation of the 1930s, however, changed the picture in many countries, subjecting banks to a special set of bankruptcy rules. Why so? Since this is one of the least studied areas of both legal and financial history, the answer can be only conjectural. My own conjecture is that special bank solvency procedures were needed for three reasons: a) the difficulty of evaluating the quality of both bank capital and bank assets; b) the externalities that might derive from a bank sudden closure or liquidation; c) the fact that since banks accumulate in the course of their business an information capital that would be lost in case of liquidation, "banks usually are worth much more alive than dead even when their worth alive is negative" (Guttentag and Herring, 1983, p.8). In sum, regulators needed to be extra-

cautious in handling bank distress, and might even need to exercise some measure of forbearance, where appropriate, to sustain confidence in the banking system.⁵

A final innovation was the formalization of supervisory powers. Until then, supervision had been an American specificity. Ever since the legislation of the 1860s, state banks were supervised by State authorities while national banks were supervised by the Comptroller of the Currency, which discharged the task mainly through rather perfunctory on-site examinations paid for by banks themselves. One of the aims of the Federal Reserve Act, according to its preamble, was "to establish a more effective supervision of banking in the United States". Accordingly, the Fed was endowed with supervision rights over its member banks similar to those of the Comptroller. At the beginning, however, the Fed, which as mentioned before relied mainly on the real bills doctrine to guide its operations, did not take this specific function at heart, lest there could arise frictions with the Comptroller. Thus, in practice it restricted itself to occasional examinations of the State Banks which had volunteered to become members of the Federal Reserve System, leaving the supervision of the National Banks, which by law were obliged to be members of the System, to the Comptroller. By the early 1930s, however, it had become clear, not only in the United States, that the failure to establish effective supervision was one of the main roots of banking instability. In many countries, the distressed banks' balance sheets were found replete with false entries and misrepresentations. Transferring bad assets from one affiliate to another just before examination was also found to have been common practice, as it was lending to the banks' own managers and shareholders (Allen et al., 1938). Thus, how to achieve effective supervision became a hot political issue. Italy in 1926 and Japan in 1928 introduced formal and extensive supervisory powers, charging with their execution respectively the central bank and the ministry of finance. In the US, in March 1932 the Federal Reserve Board raised the issue explicitly, by stating that "to an effective reform of banking it is essential a unified banking system placed under national supervision" (quoted in Klebaner, 1991, p. 346). In that country things went otherwise, as we know. The Emergency Banking Act of 1933, while greatly strengthening the supervisory technical machinery, instead of unifying supervision introduced yet another regulatory agency, the Federal Deposit Insurance Corporation. Other countries, like Germany, France, Belgium, and Switzerland, placed supervision at the center of regulatory reform. Among the big powers, Britain was the only country preferring the informal route, even though the issuing of "recommendations" by the government and the central bank to commercial banks became an accepted practice.

The goal of supervision was that of facilitating an on-going information exchange with banks, if necessary accompanied by fines and other forms of punishment in case of either misreporting or misconduct, which could turn useful not only for reducing the probability of instability, but also for monetary policy and crisis management purposes (Allen *et al.*, 1938). In the midst of a crisis, in fact, that is exactly when Bagehot's rule ceased to be a reliable guide for action and good information became scanty, authorities could turn to the supervisory record for a preliminary, but often robust, assessment of the concerned banks' true state of health.⁶ The appropriate course of action could then be chosen accordingly.

⁵ In our days, some would question the wisdom of leaving so much discretion in the hands of bank regulatory agencies, and in the United States this concern has led to introduce Prompt Corrective Action clauses in bank solvency procedures. But it is a fact that in most of the advanced countries, including the United States, still in our days there exist special bankruptcy procedures for banks, which give the regulatory authority greater room for maneuver than ordinary procedures. More on this in Section 2.3.

⁶ The legislation of 1933-35, for example, mandated that "each Federal Reserve bank was to keep itself informed of the general character and amount of the loans and investments of its member banks, with a view to ascertaining whether undue use was made of bank credit for speculation in securities, real estate or commodities, and that in determining whether to grant or refuse advances, the Federal Reserve Banks should give due consideration to such information" (De Kock, 1974, p. 239).

The three pillars of the new regulatory regime erected on the ashes of Bagehot's simple rule - special bank legislation, structural controls, and bank supervision - thus formed a coherent whole. Special legislation endowed regulatory authorities - whose technical autonomy had also been strengthened in the process - with more powerful tools and greater discretion in the pursuance of bank stability. Structural controls, by curbing competition, de facto reduced the gray area where discretion would need to be exercised. Pervasive bank supervision, on its part, ensured that any decision in crisis times would be based on better and more updated information than would otherwise be the case.

This complex set-up was intrinsically “national”, although it did not imply financial autarky, or capital account inconvertibility, as a logical necessity. It was "national" for various reasons. First of all, because the control of credit was aimed at reaching targets, such as accelerating the development of certain sectors of the economy or certain laggard regions, which were relevant only in a national context. But it was necessarily national also from an institutional standpoint, since, as remarked above, to be effective the safety net needed to be embedded in a far vaster network of institutions, from corporate law, to property rights and accountancy rules, which in turn derived their legitimacy from being perceived as part and parcel of the country's historical and cultural heritage. And it was national at a deeper level still, since such a complex implicit contract could work only on the condition that the state accept the role of guarantor and enforcer. This role implied, among other things, standing ready to use taxpayer's money to cover the losses resulting from insuring depositors - implicitly, as in the American tradition, or implicitly, as in the European one - against the risk of bank insolvency, or from administering the incentive needed to nudge commercial banks into cooperative bank rescues. As Goodhart and Shoenmaker (1995) have remarked, "he who owns the pipe calls the tune": the national taxpayer had every right to shape the national safety net as best it suited national tastes and even idiosyncracies.

2.2 The Bretton Woods framework: towards financial *dirigisme*

Although the regulatory changes of the early 1930s were indeed dramatic from many angles, few countries, except for those falling under totalitarian rule, actually tried to direct the financial industry towards social goals other than financial stability. Monetary policy remained throughout the 1930s basically orthodox, although some unorthodox policies were also contemplated.⁷ World War II, with its unprecedented financing requirements, changed the climate in a lasting way, by also providing a crucible for testing forms of intervention that were later to become standard practice. The Bretton Woods international monetary regime that emerged from the war is often praised as a model of multilateralism and economic openness. As far as it goes, it certainly deserves that praise. But it is seldom recalled that the viability of the Bretton Woods regime rested on financial repression, externally and internally. Keynes was the most adamant advocate of heavy-handed government intervention, but H. D. White, the American negotiator, was also convinced that the emerging welfare state had to be protected from capital flight initiated for "political reasons" or induced by a desire to evade the "burdens of social legislation" (Helleiner, 1994, p. 34). In light of the importance both Keynes and White assigned to national policy autonomy, it is therefore not surprising that the treaty enshrining the new international monetary regime should contain no reference whatsoever to financial regulation and supervision. According

⁷ In 1938, for instance, the Board of Governors of the Federal Reserve discussed the possibility of creating an instrument of policy out of its supervisory activities, and formally raised the question: "Can the examination policy of the several Federal supervisory agencies be further coordinated to promote the effective functioning of the entire banking system, making it a force toward increased national stability?". Although a common procedure for bank examinations was eventually agreed, there is no evidence that supervisory policies were subsequently integrated into monetary or credit policy. See Bopp (1944).

to the new international regime, states would remain free to regulate their financial industry in whatever way they saw fit to promote national prosperity. True enough, nothing obliged them to intervene heavily in the financial industry. But the implicit assumption was that they would. As a matter of fact, if one could speak at all of a conscious collective effort by the Bretton Woods signatories in the financial sphere, it had to do not only with keeping finance a national concern, along the lines advised by Keynes a decade earlier, but also with ruling out unilateral liberalization of the capital account (Helleiner, 1994). The overall outcome was a dramatic and durable fall in capital mobility (Table 1).

Domestically, the new policy regime was buttressed by a number of changes, which took place both at the institutional and at the operational level. To mark their instrumentality toward the social goal of full employment, many central banks, among which the Bank of England and the Banque de France, were nationalized (Capie *et al.*, 1994). Where for historical and political reasons this seemed an unacceptable step, as in the United States, they were subjected to new legislation mandating them to cooperate with the government towards maximizing employment. Whatever the legal tool used, the basic message was identical: control on banks had to be put at the service of macroeconomic and allocative policies.

At the operational level, a first notable change was the adoption by central banks of rationing practices in their liquidity dealings with banks. While this type of rationing had a honorable history dating back to the first phases of central banking, it had all but been forgotten in favor of interest rate control by World War II. It was resumed by several primary central banks, such as the Banque de France, the German central bank, and the Bank of Japan, to speed up the impact of monetary policy on credit aggregates (De Kock, 1974). Rationing was soon supplemented in a number of countries with the imposition of ceilings on bank lending, often used or modified in association with increases in cash-reserve and liquid asset requirements. A final innovation was the introduction of selective controls, aimed at channeling credit towards what were regarded by the authorities as the socially most beneficial uses - usually the export industry, or capital-intensive sectors. Popular in particular in developing countries, such as Mexico, India, and New Zealand, selective controls were adopted also in a number of industrial countries, most notably, the United Kingdom, Italy and France.

The sum of structural controls aimed at limiting competition and of direct controls aimed at macroeconomic purposes had the overall effect of turning banking nationalism into outright banking *dirigisme* - hardly a form of market-augmenting government. This outcome, one could argue, was already implicit in the philosophy of the Bretton Woods regime. In any case, it received unqualified support from what is perhaps the most influential policy document of the post-war period, the UK's Radcliffe Report of 1959. There, it is explicitly stated that

"the present (UK) system does work satisfactorily for the authorities; and there is not ground for supposing that it provides, at government expense, unreasonably high profits for market institutions; we suggest therefore that there is no case for deliberately disrupting it. [...] Acceptance of this view implies acceptance of certain restrictive practices in the banking system".

But in fact the tide had already begun to ebb, under the pressure of a growing awareness of the social costs of financial repression. In 1957 a group of key European countries had signed the Treaty of Rome creating the European Economic Community. The Treaty called on signatories to undertake the progressive abolition "between themselves of all restrictions on the movement of capital belonging to persons resident in Member States" (Article 67 (1)). As a first step towards this goal, the EEC ECOFIN Council's first directive of May 1960 required member countries to free short-to-medium term trade credits, direct investments, and cross-border trades of listed shares. A

further sign that things were changing was, in the early 1960s, the failure of the major countries' authorities to take coordinated actions towards the emergence of the so-called euro-markets, whose existence stemmed from banks' attempts to circumvent national restrictions, especially the United States' Regulation Q. Instead of aiming at limiting the development of, let alone at suppressing, the euro-markets, the response of the major countries' authorities was directed at ensuring a coordinated management of international liquidity as well as an orderly transition to capital account liberalization. Thus, while the OECD elaborated a Code of Liberalization of Capital Movements, the G10 established first the General Arrangements to Borrow, and then a central bank network for swapping international foreign-exchange reserves.

Other, and more visible, signs were to follow soon. In France, for example, the compulsory split between *banques de dépôts* and *banques d'affaires* was repealed as early as 1966. In other countries, in the same period the restriction of commercial banks to short-term deposits and short-term loans was partly lifted (Revell, 1981). But it seems apt that the announcement of a completely new policy course should come from the United Kingdom, the country that had first theorized and endorsed the previous regime. Under a package known as Competition and Credit Control, in 1971 the Bank of England announced its intention to abolish all existing credit controls:

"to strike off the shackles that had been frustrating initiative and innovation in the provision of financial services and to allow banks more scope for competition and innovation by moving away from a system based on quantitative restrictions to a generalized method of control where the allocation of credit is determined principally by its cost" (Annual Report of the Bank of England for 1971-72, quoted by De Kock, p. 243).

True, the policy shift was at the beginning more apparent than real. In the United Kingdom as elsewhere, the demise of the Bretton Woods exchange-rate system, first, and the First Oil Shock, later, forced the authorities to go back precipitously to the old ways. As a result, and quite paradoxically, the 1970s will probably go down in history as the most *dirigiste* decade in the modern history of economic policy. But the underlying reasons were robust. Towards the end of the decade, under more auspicious macroeconomic conditions, the shift from structural to prudential controls resumed, to become soon a nearly universal phenomenon.

2.3 Financial liberalization and constructive ambiguity

At the beginning of the 1970s, financial repression was still widespread. According to the metric developed by Williamson and Mahar (1998), only one of the main industrial countries, Germany, could be considered at the time to have a highly liberalized financial system.⁸ Five out of nine were still predominantly repressed; in particular, four had a large share of the banking system under governmental control and six had in place controls on capital movements. Even the United States was far from having a fully liberalized financial system, since it maintained Regulation Q, it limited the assets that savings and loan institutions could acquire, it prohibited interstate banking. In developing countries, with the exception of Hong Kong and Singapore, heavy financial repression was universal.

Today, the picture is dramatically different. Capital flows have been fully liberalized in all the industrial countries, and the structural controls that remain in the financial system, as Williamson and Mahar (1998) remark, are for the most part purely "vestigial". Significant steps have been taken also in the developing world, with the demise of directed-credit programs and

⁸ Williamson and Mahar identify six dimensions of financial regulation: credit controls, controls on interest rates, barriers to entry, limitations on banks' operational autonomy, state ownership, controls on capital flows. For each dimension, they classify countries as repressed, partly repressed, largely liberalized, or liberalized.

interest rate controls. Most developing countries have taken steps to increase competition in the banking system, although there often remain high barriers to entry for foreign banks and state-owned banks in several countries still account for a large share of the banking sector. In the meantime, as shown in Table 1 capital mobility has returned to levels comparable to those prevailing before the Great Depression.

Some view this remarkable shift as the inevitable outcome of exogenous technological innovation.⁹ Others have emphasized conscious policy choices made in the key country, the United States, in the late 1960s, and the resulting process of regulatory arbitrage, reinforced over time by the strongly pro-market policies of the Reagan Administration in the US and the Thatcher government in the UK (Helleiner, 1984; Strange, 1998). Others, still, have traced its origin to the increase in capital mobility made possible by the restoration of current account convertibility in the late 1950s (Eichengreen, 1996).

There is no need to regard these views as incompatible. The decision not to take regulatory action to counter the development of the euro-markets in the 1960s - itself facilitated by the return to current account convertibility - probably heightened the pressures to which domestic regulatory systems were exposed. And certainly technological innovation played an important role in the process. But most of the pressure toward liberalization came from within the economy, spurred by at least three forces. First, the growing inefficiencies associated with financial repression, with banks requiring ever larger interest-rate margins to compensate rising operational costs. Second, the expanding cross-subsidization of activities within the banking sector. And, last but not least, the fact that non-bank financial institutions began, thanks to financial innovation, to make inroads into the more profitable parts of the banks' traditional franchise. Outside competition, in turn, led banks themselves to seek new ways to keep their market share.

The liberalization wave was intended to remove those restrictions impeding free credit allocation, or directing banks towards monetary policy objectives, not to free banks from controls and forms of governmental interventions aimed at financial stability (Borio and Filosa, 1994). In other words, it was directed at structural controls, not prudential ones. Even though at the beginning of the process many referred to it as financial "deregulation", the expression was later superseded by financial "regulatory reform", as people increasingly realized that in the new, highly competitive, environment that was taking shape what was needed was better, and perhaps more market-friendly, regulation, rather than less (Crockett, 1997). At about the same time, concern for the lack of competition within the banking sector began to surface in policy circles for the first time since the 1930s (Broker, 1989).

The repeal of structural controls and the growing emphasis on the benefits of competition clearly meant accepting a larger dose of instability, at least during the financial industry's transition to the new environment. The resurgence of bank instability occurred in different periods, forms and impact depending on local policies and economic circumstances, but has been a widespread phenomenon in the recent past. Lindgren, Garcia and Saal (1996) report that over the 1980-96 period at least two-thirds of IMF member countries experienced significant banking sector problems. The phenomenon has not been confined to developing countries. Spain set the stage in the late 1970s, followed by the Nordic countries (Finland, Norway, and Sweden) and the United States in the second half of 1980s, France, Italy and the United Kingdom in the 1990s. What differentiates banking crises in the developed countries from those in emerging market countries is

⁹ Herring and Litan (1995, p. 13), for example, identify as the main driving force "the dramatic reductions in transportation, telecommunications, and computation costs, (which) have greatly increased the ease with which firms can bridge the natural barriers of time and space that separate national borders".

the cost in terms of GDP that they entailed, which remained reasonably low by comparative standards (Table 2).

One may be tempted to call this phenomenon historically “unprecedented”, but such a statement would be either uninformative or plainly wrong. It would be uninformative if taken to mean that banking crises of such size had never been seen before, because in no time before were banking system as developed and as important from a macroeconomic perspective as they are today throughout the world. Or wrong, if interpreted as meaning that financial crises of our days are more disruptive than they used to be. As De Long (1999) and Bordo and Schwartz (2000) have shown, financial crises in the pre-Bretton Woods period were as severe in terms of real consequences (and even more severe if one includes the Great Depression period in the sample) as they are today.

Bank defaults are to some extent a natural feature of financial regimes that assign to market discipline rather than to intrusive regulation the task of chastising unsound risk-taking. But what accounts for *large* bank instability? This is the subject of a growing empirical literature, which however has to date produced very little consensus. *Prima facie*, it would seem that capital reversals made possible by greater cross-border mobility of finance are to be blamed (Figure 1). But this conclusion is not supported by more in-depth statistical studies. The only robust finding, as Eichengreen and Arteta (2000) remark in a comprehensive survey of the empirical literature, is that domestic credit booms are strongly associated with banking crises. As shown by Lopez-Mejia (1999), the vulnerability of the financial sector as a result of lending booms has often been strengthened by a surge in asset prices that at the end proved unsustainable. Apart from this, next to nothing can be said with a reasonable degree of certainty on the underlying causes. There is some evidence that a weak institutional environment tends to be associated with greater instability, but Eichengreen and Arteta (2000) caution against placing too much confidence in the rather crude indicators used for this as a proxy of institutional quality. By contrast, the evidence supports neither the view that fixed exchange regimes tend to increase the probability of a banking crisis, nor that which sees external financial liberalization and capital reversals as directly responsible for bank instability. If anything, the opposite seems closer to the truth.

The new wave of crises has been dealt with the instruments afforded by the existing regulatory regime. But it has also raised the important policy question of how to manage and to the greatest possible extent prevent bank instability in an environment which featured competition as a key component. It was, in essence, the old crisis management question in new dress. The response took the form of what is now universally called the policy of “constructive ambiguity”. Constructive ambiguity is a complex notion, encompassing, in addition to uncertainty as to whether public support of distressed banks will take place at all, uncertainty regarding both the exact timing of the intervention and the terms and penalties attached to it (Freixas *et al.* 2000).¹⁰ Constructive ambiguity can be regarded as a way to deal with the time inconsistency problem from which a generalized hands-off policy in banking would be affected. In fact, while it is in the interest of the authorities to deny their willingness to provide a safety net, *ex post* they may find it optimal to intervene.

But what makes such a policy credible in its own right? A first requirement is that there exist truly alternative options, including orderly liquidation, to deal with a crisis once it breaks out,

¹⁰ To the best of my knowledge, the first explicit mention of constructive ambiguity is due to the then President of the Fed of New York, Gerald Corrigan, who in May 1990 stated, in a testimony before the US Senate Committee on Banking, Housing, and Urban Affairs Chairman: “I believe that the workings of both the safety net and market discipline will be better served in a context in which the authorities maintain a policy of what I like to call “constructive ambiguity” as to what they will do, how they will do it, and when they will do it. [...] In no case should it be prudent for market participants to take for granted what actions the authorities will take and certainly in no case should owners and managers of troubled institutions – large or small – conclude that they will be protected from loss or failure”.

to make sure both that the least-cost solution will be worked out and that managers and shareholders will bear their part of the burden, to alleviate moral hazard. Notice that this is an argument in favor both of having special bank solvency procedures - a need that had been already met in advanced countries, as we have seen, ever since the 1930s - and of giving publicity to the actual cases where harsh measures have been taken.

The need to enlarge the set of options available to authorities in crisis times sheds light also on another, and otherwise puzzling, phenomenon: the rise of deposit insurance. Until the 1970s, deposit insurance had mostly remained an American idiosyncrasy, and even there the introduction of the scheme had been long resented on the ground that its moral hazard implications would be unacceptable. Of the 61 countries included in the data-set constructed by the IMF to survey the practice of deposit insurance throughout the world, only six, of which only two from the industrial group, had in 1970 an explicit deposit insurance scheme (Demirguc-Kunt and Detragiache, 2000). By 1998, the figure had gone up to 36, among which one could find practically all developed nations (Figure 2). This massive move towards deposit insurance may seem paradoxical, since in the same years deposit insurance was called into question in the United States because of the Saving & Loans debacle (Benston and Kaufman, 1998). But in fact, formalized deposit insurance was now seen in many countries as an improvement over *implicit* insurance, namely the widespread perception that the government would stand ready, one way or other, to guarantee all depositors against the risk of bank default. It was in essence seen as a form of coinsurance between the public and the private sector. Accordingly, in most cases the source of funding was either the private sector itself, or a combination of state and commercial bank money. As a further proof of the new philosophy, some of the newly-introduced schemes, especially in European countries, have been given the power to acquire control of ailing banks for the purpose of resolving their problems without resorting to outright liquidation and the consequent repayment of depositors.

A key factor in the spread of deposit insurance was its inclusion among the qualifying features of the EU's Single Market project. As early as 1986 the Commission of the European Communities recommended that it would be appropriate for the credit institutions of all member states to participate in a deposit guarantee scheme. In 1994, that recommendation was transformed into a legally binding "directive". Between 1994 and 1999, 24 countries in Europe - members and non-members of the EU alike - either adopted an explicit deposit insurance scheme or revised the existing one on the basis of the directive's guidelines (Arrigunaga, 2000).

A second requirement to make constructive ambiguity credible is that the authorities should be equipped with better skills, better information, and better incentives to arrive at a prompt assessment of the circumstances of specific crisis episodes, so as to be able to fine-tune their response at the least social cost. The response was a generalized strengthening of supervisory arrangements and prudential controls. For instance, the UK passed a new banking law in 1979, France and Germany in 1984, Italy in 1993. The issue of setting the right incentives for the regulators was particularly felt in the United States, where regulatory forbearance had been identified as one of the main causes behind the Savings & Loans crisis. The 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) is an attempt to devise regulatory sanctions for insured institutions that mimic those the market imposes on uninsured companies. The key component of the scheme is a gradation of regulatory interventions meant to address increasingly severe under-capitalization problems, with the worst grade being associated with mandatory bank closure.¹¹

¹¹ FDICIA is often cited as a rule-based regulatory framework, as opposed to more discretion-based ones. While the desire to reduce the room for forbearance was central in the mind of the legislator, it is widely recognized that FDICIA puts even heavier demands on the regulator's competence and dexterity, the more so since it requires regulatory agencies to develop a means for estimating market values for the banks' capital "to the extent feasible and practical".

But, since asymmetric information is an inevitable feature of banking and the growing complexity of banking itself makes it unlikely that authorities would ever gain a complete picture of any bank's balance sheet under stress conditions, the most important requirement was that the banks operated under the right incentives to steer clear of trouble. This could only be achieved through preventive action. Structural controls and limits on competition having been ruled out by assumption, the only option left was to work at strengthening the banks' capital basis and risk assessment capabilities. As Crockett (1997, p. 27) puts it:

"A more competitive environment put pressure on profits and made cross-subsidization of unprofitable activities harder to sustain [...] Previously, loan losses could be carried on a bank's books until made good by subsequent profit flows. In a more competitive environment, they risked calling the banks' solvency into question. [...] The new focus [...] was to ensure that banks had adequate capital to make them resilient to the risks they faced. Such a focus could be thought of as an attempt to overcome moral hazard by mimicking competitive behavior as it would exist in the absence of problems of asymmetric information".

This was the logic that led to regard capital requirements as the backbone of bank regulation. The defining moment in the transition to the new approach was the debt crisis of the early 1980s, which came close to destabilizing the banking system in a number of major developed countries. It was the LDC debt crisis, in particular, which set in motion the process that was to lead to the Basel Capital Accord, reached in 1988. With the advent of capital ratios the shift from structural to prudential controls as a means to achieve financial stability was for all practical purposes completed.

While most of the action to upgrade the regulatory environment had to take place at the national level, it is often overlooked how crucial international cooperation was all throughout. I have already mentioned the role of the of the Single Market project in the spread of deposit insurance in Europe. Cooperation was even more crucial for the success of the transition to the new capital-based approach to prudential control, because in the context of liberalized capital markets unilateral adoption of the new standard would have entailed the risk of regulatory arbitrage. A coordinated move was needed to ensure a "level playing field" for all the institutions involved.

The story of capital ratios deserves to be recounted in somewhat greater detail because it epitomizes at once the potentialities and the limitations of informal cooperation in the regulatory domain. Still in the first half of the 1970s, in accordance with the Bretton Woods regime, international cooperation in matters related to financial regulation was practically non-existent. Things abruptly changed in 1974 in the aftermath of the failure of three internationally active banks, Bankhaus Herstatt of Cologne, the British-Israel Bank of London, and the Franklin National Bank of New York. In particular, the large spillover effects from the sudden closure of Herstatt, which was a relatively small bank, drew the attention of the industrial world's authorities to the growing interdependence of the international banking system - and to the difficulty of managing crises in such an environment. The immediate result was a statement by the central bank governors of the Group of Ten announcing that while it was not "practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity", the means were available for that purpose and would be "used if and when necessary". It was the first outline of the policy of constructive ambiguity that would subsequently reshape the structure of financial regulation. A yet more far-reaching consequence was the establishment of the Standing Committee on Banking Regulations and Supervisory Practices, which later came to be known as the Basel Committee.

Even the most automatic component of the framework, the prompt corrective action provision, embodies on closer inspection a non negligible judgemental element. See Goldstein and Turner (1996).

Informal, deprived of legal force, but highly authoritative due to the homogeneity, technical competence, and reduced number of its members, the Basel Committee has stood behind most of the main regulatory changes of the last three decades in the financial realm.¹²

In its first years of activity, the Basel Committee concentrated on ensuring that all internationally active banks had a clearly established “home supervisor”, and that there was a well-understood division of responsibilities between home and host authorities. A major stumbling block along this path was the existence in most countries of secrecy laws, which constrained the relevant national regulator in its freedom to exchange information needed to judge the solvency of a banking entity. To modify this, a long and scarcely visible legislative and administrative process had to be set in motion. A significant progress in this respect was, in 1978, the adoption of the principle of consolidation, which stipulated that banks' international business was to be monitored on a consolidated basis regardless of the jurisdiction in which it took place.

The LDC's debt crisis prompted in 1984 the G-10 Governors to charge the Basle Committee with “recommending a framework for assessing the comparability of different measures of capital adequacy used by member countries and with developing minimum international bank capital standards” (Herring and Litan, 1997, p.108). The ultimate outcome of this effort was the already recalled 1988 document on International Convergence of Capital Measurement and Capital Standards, better known as the Basel Capital Accord. The Accord required internationally-active banks to maintain shareholders' capital equal to four percent of their risk-weighted assets and a total capital ratio equal to eight percent, with different risk weights applied to individual asset categories.

Several things need to be said of this achievement. First and foremost, as far as it went, it was an astounding success. The degree of harmonization achieved in practice was impressive. Moreover, though the new standard was originally meant to apply only to internationally-active banks, many regulators, United States' in the lead, chose to apply it to the whole banking sector. Further still, while the Accord could have been expected to apply only to its signatories, in fact it was de facto endorsed by a much broader set of countries.

But the downside of the Accord was also remarkable. The need to strike an acceptable compromise among the authorities involved was responsible for significant limitations. On the one hand, the standard ignored portfolio, interest-rate, market, and some counterparty risks. On the other hand, the system of risk weights inevitably had a rather crude, rule-of-thumb character. No attempt was made to differentiate, say, the risk involved in a loan to a highly-rated blue chip company from that of a loan to an unrated small corporation or an individual borrower. Moreover, by convention it was decided to consider loans to sovereign entities in countries of the OECD as low-risk, while loans to all other sovereign borrowers would carry a 100 percent risk-weighting. In the same vein, it was assumed that interbank loans belonged to the low-risk categories. Finally, no attempt was made to ensure that the supervisory process for assessing compliance would also be harmonized, on the assumption that the Accord would be implemented by equally competent authorities in what were equally sound institutional and macroeconomic environments. As it turned out, most emerging market countries adopted the 8 percent rule notwithstanding a much more volatile environment. Also, in several of the countries which later on suffered banking problems, actual capital ratios, as officially recorded, were much higher than the minimum threshold (Table 3).

In the course of the 1990s, much ingenuity was spent by the Basel Committee in refining the Accord, so that it eventually encompassed many of the risks that had been left out at the outset.

¹² For an informed account of the history and achievements of the Basel Committee, the reader is referred to Follak (2000).

What remained unchanged all throughout were both the risk-weight system and the exclusive focus on their mechanics, as opposed to the process whereby they were implemented. Supervisors have been aware of these limitations from the outset. However, either they emphasized the merits of simplicity for the purpose of leveling the playing field across countries, or they warned that the Basel thresholds were not intended as a substitute for sound supervision (Padoa-Schioppa, 1996).

The problem went deeper, though. On the one hand, securitization and other financial innovations made it possible for banks to indulge in “regulatory capital arbitrage”, namely to reduce substantially their regulatory capital requirement with little or no corresponding reduction in overall risk taking (Jones, 2000). On the other hand, the basically conventional structure of risk weights provided incentives to invest heavily in financial instruments that enjoyed a capital privilege, regardless of their true risk profile – as became universally clear in the course of the Asian crises of 1997-98, whose run-up had been dominated by the literal explosion of international interbank lending – a low-risk form of financing according to the Basel criteria.

As a result, the new century finds the art of supervision in the middle of its biggest upheaval since the 1930s. Industrial countries’ supervisors have finally reached the conclusion that “no snapshot of a bank’s balance sheet at a moment in time, such as supervisors have traditionally examined, can hope to provide an adequate picture of its risk exposure” (Williamson and Mahar, 1998, p. 30). As a result, they have come up with a completely new approach to capital ratios, which rely on risk measures obtained from private sector participants rather than on simple formulas of their own making. The New Capital Accord built on this premise is scheduled to come into effect by 2004. This is no place to examine in any detail the revised accord.¹³ For our purposes, it suffices to note that it hinges on three “pillars”, namely reliance on banks’ own risk assessment procedures, in-depth and periodic supervisory reviews, and greater disclosure rules. One important implication of the approach is that capital requirements on a *given* portfolio will now change over time, as the assessed risk of that portfolio evolves. This will take care of the problem of wrong relative capital charges, but how is a correct risk assessment going to be made? The need to respond to this fundamental question explains why the New Capital Accord is a much more complex endeavor than its predecessor. Thus, the success of the new approach will depend to a large extent on the quality of the bank management’s and regulators’ response to the challenge posed by a more volatile economic environment. The devil, as financial history only confirms, often hides in the details.

3. The quest for a global financial standard

3.1 Taking stock of history

Before moving on to discuss the various proposals on the table to upgrade financial regulation in emerging markets, as well as the official community’s strategy towards this goal, it is perhaps appropriate to try and distill from the evolution of financial regulation in the twentieth century a few general lessons, or regularities. Although highly subjective, the following list of propositions seems to me to capture most of what can reasonably be said on the basis of what we currently know about this relatively neglected area of research.

¹³ The interested reader is referred to Basel Committee (2001) for a description and to Evanoff (2001) for a critical assessment.

Proposition 1

Confidence is crucial for the well functioning of a market-based financial system. Sustaining confidence under adverse conditions has thus been the primary force behind the development of crisis management tools. Better crisis prevention has largely been a by product of this process.

Confidence is an elusive concept. Yet, it would be difficult to understand the history of banking regulation, and of financial regulation at large, without it. Most economic models rest on the assumption that agents understand the fundamentals of the economy and have sufficient information to infer where the economy is going. However, as Borio, Furfine and Lowe (2000) remark, this assumption is often an inadequate description of the evolution of beliefs in the real world. Different sets of beliefs can be sustained by the same “facts”, and this type of observational equivalence lies at the root of several pathologies from which the financial system suffers, such as disaster myopia, cognitive dissonance, or herd behavior. The impact of these pathologies is often exacerbated by asymmetric information problems.

The evolution of financial regulation can thus be seen as the outcome of a continuous struggle to devise ways to anchor beliefs as tightly as possible to actual economic conditions. The need to do so has been predominantly felt in crisis times. When banking difficulties first emerge, the size of the potential problem is often hard to gauge. Moreover, it may not be easy to discern whether the problem is going to be temporary or permanent. Given the role of banks in the economy, the cumulative effects of a loss of confidence are equally hard to predict, and may turn out to be enormous, and to some extent irreversible. The first and foremost objective of financial regulation has thus been that of empowering the authorities with legal and institutional tools to handle crises so as to contain their size and real impact. Crisis prevention has been a later addition to the regulatory panoply, motivated by the desire to attenuate, and possibly remove, any adverse effect on incentives produced by ex post government intervention. Over time, crisis prevention has also come to play the secondary role of reducing the scope for discretionary action on the part of the crisis-management agency. Experience suggests, however, that no amount of crisis prevention can dispense with discretionary confidence-enhancing decisions by the authorities in the midst of a crisis.

Proposition 2

To be effective in sustaining confidence, financial regulation and supervision need to be embedded in (adapted to) the country’s overall institutional and legal framework. Simple (mechanical) rules are unlikely to be a reliable safeguard against instability.

The history of financial regulation began when disillusionment with simple crisis management rules, such as Bagehot principles or the real bills doctrine, set in motion a search for new ways to sustain confidence in the banking system. Subsequent experience only confirmed the drawbacks of rule-of-thumb financial regulation. As Caprio and Honohan (2000) note, for example, the paradigm of capital ratios is predicated on the assumptions that regulators are competent and motivated, bankers are relatively honest, and bank shareholders and creditors monitor the bank’s risk portfolio. If these conditions are not met, capital requirements will easily be circumvented by tampering with loan evaluation or loan-loss provisioning. This is why financial regulation and supervision need to be firmly embedded in the country’s legal and political institutions. While domestic embeddedness is no guarantee of regulatory effectiveness, as local legal practices may as easily be biased in favor of forbearance or political interference, it is nonetheless a necessary condition for market-augmenting regulation. In fact, no matter how well the regulatory framework

has been designed, the quality of the implementation will remain key, because discretionary choices will have to be made all along. It is therefore of the utmost importance that the regulatory agency operate at once under appropriate incentives, sufficient statutory authority and substantial protection from political interference and legal threat.

Proposition 3

Not only is some measure of bank instability a physiological component of a competitive financial industry. It is also necessary to buttress the credibility of constructive ambiguity. In the long-run, however, there is no trade-off between competition and stability.

It would be unrealistic to expect regulatory reform, no matter how well-meaning, to eliminate bank instability altogether, as macroeconomic volatility - one of the main sources of bank distress - is not easily eradicated. Moreover, even in countries with the most developed systems of banking supervision, many of those that later proved to be bank failures have gone undetected during bank examinations. For example, a study of the Federal Deposit Insurance Corporation found in 1996 that of the US banks that failed from 1980 to 1994, 36 per cent had received the highest examination ratings (Goldstein, 1997).

A further reason for not nurturing unreasonable expectations from regulatory reform is that some measure of instability is not only healthy to create the right market incentives, it is also desirable to sustain constructive ambiguity. The credibility of constructive ambiguity, by contrast, rests on the public's perception a) that there exist procedures for dealing with ailing banks while punishing managers of shareholders where appropriate; b) that such procedures are actually used. A corollary of this statement is that the discretion enjoyed by the regulatory agency should be compensated by ex post disclosure, since knowledge that emergency financial support will eventually be disclosed may act as a restraint on improper use (He, 2000).

The perception that constructive ambiguity coupled with bank competition entails some measure of bank instability may deter some emerging markets from liberalizing their financial sector. But this would be foolish. The once widely held belief that there is a long-run trade-off between competition and stability has long been disproved. In the short, run, liberalization may, by eroding monopoly rents, reduce the franchise value of domestic banks and even increase the incentive "to gamble for resurrection". But this is more often than not a consequence of long-standing underlying insolvency of the banking sector, concealed by financial repression.

Proposition 4

Banking crises are often the outcome of gross inadequacies in regulatory action, namely a lack of market augmenting government, whose effects get magnified by a particularly volatile macroeconomic environment or a regime shift.

It would be tempting to blame the choice of exchange rate regime, or financial liberalization, for the resurgence of bank instability. But the evidence tells otherwise. The exchange-rate regime has no obvious link with banking crises. If anything, causality goes in the opposite direction. Nor does external financial liberalization necessarily entail instability, although poor sequencing has clearly played a role in many cases (Eichengreen and Arteta, 2000). Most frequently, it is possible to trace the crisis to the sluggish institutional response to a regime shift "which altered the nature, scale frequency and correlation pattern of shocks to the economic and

financial system” (Honohan, 2000, p. 94). The institutional response proved inadequate not only in that it allowed a credit boom to set in – a credit boom being the only unambiguously recurrent factor in the recent spate of crises – but also because it failed to raise up prudential standards in many respects. Thus, risk-based capital ratios were set in most emerging markets at the level prevailing in industrial countries, notwithstanding the more volatile macroeconomic environment and a greater concentration of income and wealth. Moreover, actual capital ratios in many cases turned out to be much lower than officially declared. In the same vein, grave deficiencies were allowed to build up in the classification of loans. One such deficiency was the practice of letting interest accrue on non-performing loans for up to a year before taking action. Another well-established pattern in the 1980s banking crises in Asia and Latin America was that banks were allowed to continue, long after the crisis had broken, to extend new credits to roll over the debt service obligations their customers could no longer meet – a practice that came to be known as “evergreening”. All this testifies to the difficulty of moving from the level of abstract principles and rules to that of implementable (and actually implemented) procedures. As a recent report by the World Bank (2001) concludes, no matter what “headline” regulation says, the convergence of emerging markets to industrial countries’ norms remains to date more superficial than real.

Proposition 5

The growing complexity of financial activity is forcing in industrial countries a thorough rethinking of financial regulation and supervision. The emerging approach, however, poses even greater demands on regulators and supervisors alike.

Dissatisfaction with the performance of mechanical capital ratios in the face of the growing complexity of financial instruments and markets is leading regulators in the industrial world to experiment new tools. The gist of the new approach relies more on auditing the bank’s risk management systems than on assessing the state of the balance sheet at a moment in time. Needless to say, this change in approach represents a formidable challenge for supervisors. Not only will they need to equip themselves with the competence to evaluate the risk-assessment framework employed by a bank, and to reassure the supervised banks that their proprietary knowledge will be protected. They will also have to introduce appropriate disclosure rules, and a set of credible penalties for misreporting. Moreover, it ought to be recognized that the new approach represents an attempt to rectify current problems with *relative* capital charges. One obvious implication of the approach is that the capital requirements on a *given* portfolio will change over time, as the assessed risk of that portfolio evolves (Borio, Furfine and Lowe, 2001). If *absolute* risk is measured accurately, then all will be well. But if one is to judge on the basis of the behavior of loan provisions, the banks’ internal risk assessment procedures in the past have been characterized by marked procyclicality. If nothing is done to correct this pattern, capital requirements would risk becoming themselves strongly procyclical - hardly an improvement upon current practices.

Propositions 4 and 5 combined should make us wary of quick fixes. Neither nominal compliance with headline regulation nor the simple replication of the new approach being experimented in the industrial world – in an environment that is at present institutionally much weaker - are likely to be effective solutions to bank instability in emerging markets. In such circumstances, setting in motion the right process to upgrade the institutional environment should be given a higher priority than looking for the ideal model of bank regulation. “When you don’t know what you’re doing, do it gently”, goes the old maxim. Short-cuts, the history of financial regulation in the industrial world suggests, will simply not do.

Proposition 6

For crisis prevention purposes, the internal consistency of the regulatory regime is more important than the specific design of any of its components.

Taken in isolation, no component of the safety net may be deemed “desirable”. What matters is the internal coherence of the whole design and, above all, the predictability of enforcement. One prominent example is deposit insurance. Credible deposit guarantees undoubtedly do forestall runs. But they equally undoubtedly raise moral hazard. The most persuasive argument in favor of explicit deposit insurance is that it can represent a limit to the government’s commitment to depositors. Explicit but limited coverage may be preferable to implicit but unlimited coverage. Also, an explicit scheme may make it easier to close a bank by obviating the need for expensive litigation with small depositors. But these benefits are all theoretical. The actual impact of deposit insurance is bound to depend on the overall robustness of the institutional environment. As argued by Garcia (2000), an incentive-compatible deposit insurance system presupposes appropriate objectives, well-defined roles and responsibilities for the various actors involved, and above all a supportive infrastructure to ensure good internal and external governance of banks participating in the system. In fact, contrary to a popular view, according to which deposit insurance is needed in poor countries to give savers confidence in the banking system, the empirical evidence points out that in institutionally weak countries having explicit deposit insurance leads to less financial sector development and greater instability (World Bank, 2001). This may have to do with both the signal provided to depositors when explicit insurance is introduced (what was until then only probable becomes at that point certain) and the bank’s awareness that the domestic supervisor may not have the right skills and incentives to detect free-riders.

Proposition 7

International cooperation has been a driving force in shaping international financial relations ever since World War II.

This proposition may be ranked at first blush among the most controversial in the list. But in fact, Helleiner (1994) has convincingly argued that the viability of the Bretton Woods framework rested on the major economies cooperating towards the goal of restraining capital mobility. Only by doing so could the Bretton Woods regime be sustained. As such, Bretton Woods should be counted among the success stories of international cooperation also in the area of finance. The framework began to falter as cooperation became laxer – itself the result of the major countries beginning to realize the benefits of a more liberal financial system. When the exchange rate mechanism eventually collapsed, the national authorities’ attention turned to coordinating their response to growing capital mobility. This response followed two separate, but equally discernible, courses. The first was the highly informal, at time secretive, Basle process, which aimed at forming a relatively homogeneous community of regulators sharing common views and values. The second, whose origins can be traced to the Treaty of Rome, back in the 1950s, was the highly formalized approach followed in the European Union for the creation of a single market for financial services. The lack of flexibility such a formal approach could entail, as well as the greater potential conflicts among states due to its broad scope, were remedied by devising a reform strategy that relied to a large extent on the dual notions of mutual recognition and subsidiarity. Cooperation remains crucial in our days, because the historical evidence suggests that, no matter how effective financial reform is, capital flows are likely to return to crisis-stricken countries. As a result, governments presiding

over emerging market countries may be under insufficient pressure to pursue far-reaching reform on their own (De Long, 1999).

3.2 A World Financial Authority?

The number and magnitude of banking crises in the developing world over the last two decades is absolutely astounding. Defining a crisis as a situation in which the banking system's capital is exhausted as a result of recorded losses, Caprio and Klingebiel (1996) count 67 such crises since 1980, of which 52 in developing countries. The figure has of course since then grown even higher as a result of the Asian crises. As shown in Section 2, resolution costs around 10 per cent of GDP or more have not been infrequent. Honohan (1996) estimates at about \$250 billion the total resolution costs in developing and transition economies since 1980.

In light of the heavy costs, in terms both of domestic output and potential spillover effects due the growing integration of capital markets, the temptation to invoke radical solutions is indeed great. Barring a generalized return to the financial repression of the Bretton Woods era, the next most radical option would be the establishment of some form of centralized regulation and supervision at the world level.

In its most extreme form, such a scheme has been advocated by Eatwell and Taylor (2000). They advocate the establishment of a World Financial Authority (WFA) "to perform in the domain of world financial markets what national regulators do in domestic markets" (p. x), namely "information, authorization, surveillance, guidance, enforcement, and policy" (p. 220). The main purpose of the scheme is to formalize the Basle process, as now embodied in the Financial Stability Forum, so as to give it surveillance and enforcement powers.

Although Eatwell and Taylor do not discuss at any length how enforcement powers could be centralized, they suggest a "carrot" mechanism to induce acceptance of WFA best practice regulation. WFA approval of national regulatory structures, they argue, "could be deemed a form of pre-conditionality, allowing a country threatened by financial volatility rapid access to the lender of last resort" (p. 232). An analogous, if somewhat milder, scheme has been proposed by Soros (2000). He suggests entrusting the IMF with the task of monitoring compliance of its member countries with standards of sound financial regulation and to classify them according to performance, ensuring better conditions of access to its loans to well-behavers, while non-performers would be left to extricate themselves, through debt default and the ensuing restructuring, from any external crisis they may incur. Soros' scheme is in turn reminiscent of the recommendations formulated by the Meltzer Commission in March 2000. The Commission, too, suggests that countries should pre-qualify for IMF support, listing adequate capitalization of banks, openness of the domestic financial system to foreign competition, and disclosure of data on the maturity structure of outstanding sovereign and guaranteed debt and off-balance sheet liabilities as the crucial prerequisites. The Commission's requirements, to tell the truth, stop short of asking countries to comply with internationally-set regulatory and supervisory standards, and therefore would seem easier to meet than Soros' prerequisites. It is therefore somewhat surprising that Soros should find them too strict, on the ground that *"it is doubtful whether many countries would qualify and if they did whether it would them much good. Not much moral hazard there - but not much help to emerging economies, either"* (p. 274). Be that as it may, the idea of pre-selection has been to a certain extent already embodied in one of the IMF facilities, the Contingent Credit Line (CCL), established in 1999 with the purpose of providing member countries with a strong track record of economic and regulatory policies quick access to large amounts of external funding in case they are hit by financial contagion. Among the pre-conditions for access to the CCL, one finds adherence to

relevant internationally accepted standards (and in particular subscription to the Special Data Dissemination Standard administered by the IMF itself). As is well-known, though, the CCL has not been well-received by potential candidates, which fear that their application to the scheme could be interpreted by the markets as signaling the existence of external financing problems.¹⁴

The internationalization of crisis management, rather than an option among others, seems to lie at the very root of the idea of centralizing the regulatory process. We have already seen that financial regulation emerged at the domestic level from the need to devise procedures at once to reduce the probability of insolvency and to allocate losses so as to strike a balance between ex ante and ex post efficiency. State intervention was made necessary to reconcile taxation and representation of the ordinary citizen, since, as Goodhart and Schoenmaker (1998) have put it, "he who owns the piper calls the tune". If the regulatory process were to be centralized, so should be the process of crisis management.

It would be easy to turn down such schemes on the ground that they lack political feasibility. However, it would also be beside the point. Their advocates could retort that the same criticism was raised against the proponents of central banking, such as Walter Bagehot, in the second half of the nineteenth century, and that sooner or later politicians will be forced to face the reality of things - unpalatable as it now may feel. What really matters is whether their suggested reform proposals could ever stand on their own feet and could over time prove a net improvement over the existing decentralized set-up.

I contend they could not, for two reasons. First, to avoid controversy and political tampering, performance should be evaluated on the basis of criteria that should be limited in number and simple in form, as is clear from example from the recommendations of the Meltzer Commission. But the idea that regulatory soundness can be so gauged, while widespread perhaps until a few decades ago, is by now outdated, as we have seen in Section 2. Present trends in the regulatory area go towards forms of intervention that presuppose, if anything, a greater need for interpretation and fine tuning. It would be paradoxical to "force" emerging markets to adopt modes of intervention that have already proven inadequate in developed countries. But suppose it could be possible to identify a limited number of criteria of regulatory performance. Would the system work? Again, no. Underlying all three proposals, there is the idea that ex ante compliance with regulatory and supervisory standards is what makes it possible for central banks, and by analogy for an international regulator, to act swiftly and without limits in emergencies. Eatwell and Taylor (2000) say so explicitly:

"Today, IMF "conditionality" attached to its credits prevents the development of a successful lender of last resort function. Money with strings, and money much delayed, is not liquidity. Effective regulation replaces some of the conditionality strings" (p.25)

Similar passages can be found both in Soros (2000) and in the report of the Meltzer Commission. But this view is based on a confusion between lending of last resort with respect to the markets and lending of last resort with respect to individual institutions. Unconditioned and (potentially) unlimited lending has been practiced by central banks only to stop sudden lapses of confidence in securities markets. Even then, it was accompanied, contrary to what the Meltzer Commission suggests, by a reduction in interest rates, not by penalty rates. Moreover, in such instances, regulatory and supervisory compliance on the part of individual market participants is irrelevant. When it comes to rescuing individual intermediaries, by contrast, lending of last resort

¹⁴ To make it more attractive to eligible members, in March 2000 several aspects of the CCL were modified. In particular, the degree of automatism of activation was increased, and the financial terms made less punitive for borrowers. To date, however, no country has yet applied.

usually comes on the basis of a case-by-case assessment, through the activation of appropriate administrative or legal procedures meant to punish those responsible, according to the doctrine of constructive ambiguity. While the supervisory record may be of help in arriving at a first assessment of whether the crisis is one of "illiquidity" or "insolvency", it is in no way a substitute for careful evaluation and on-site assessment. At the international level, the need for caution is, if anything, stronger, in view of the fact that the country itself is the producer of most of the information on which assessment is to be based, and that due to domestic political uncertainties the country's authorities may find it harder to commit to a sound policy course (Giannini, 2001). Experience with banking crises in industrial countries over the last two decades shows that a prima facie good regulatory record is not sufficient to rule out the possibility of even large episodes of instability. Nor can one blame many of the recent banking crises on the prior break-out of a currency crisis, which would be made impossible by the availability of prompt and massive external finance. Indeed, most of the empirical evidence we do have converges towards the conclusion that, if anything, it is banking crises that cause currency crises, and not the opposite (Eichengreen and Arteta, 2000). The notion of conditionality, which, it is to be noted, was not included in the original IMF Charter, developed out of the experience the IMF accumulated in its dealings with sovereign countries. It was conceived as a means to protect its resources against abuse, and to avert moral hazard, in a world where enforcement powers are limited and information asymmetries abound. We are better advised not to exchange it for a view of central banking whose analytical underpinnings and empirical relevance are yet to be demonstrated.

3.3 The soft law approach

Once the creation of a supranational regulatory body endowed with enforcement powers is discarded, there remains two possible strategies for reforming the international financial architecture. One consists in trying to make countries agree on a new world treaty that could be given the force of "hard" law, perhaps mimicking at the world level what the European Union has done at the regional level. The other relies instead on a more formalized, but not enshrined in any binding agreement, version of the Basel process, hinging on the formulation of recommendations, guidelines, or other arrangements of a non-binding nature, internationally promulgated but whose implementation would be in essence left to national authorities, but with incentives such as "peer pressure" or "market discipline".

The latter strategy, which has been labeled "soft law approach", due to the fact that its content has neither the strength of ordinary law nor the weakness of sheer international conventions, was first proposed by Goldstein (1997) under the label of "international banking standard". It was adopted by the official community in early 1999, with the establishment of the Financial Stability Forum (FSF), after the Willard Groups had reached the conclusion that it would have been impractical, cumbersome, and perhaps also perilous, to pursue the "hard law" strategy in a world comprising almost 200 sovereign entities. The FSF is a true novelty in the panorama of international cooperation. Its mandate is to improve coordination and the exchange of information between the various authorities responsible for financial stability; besides, the FSF is entrusted with assessing vulnerabilities affecting the international financial system and identifying and overseeing action needed to address these vulnerabilities. In the FSF there seat for the first time side by side representatives of finance ministries, central banks, and regulatory agencies of a number of countries (the G7 plus Australia, the Netherlands, Hong Kong and Singapore), plus representatives of the international financial institutions, of the ECB and of the main regulatory groupings (such as the Basel Committee).

The soft law strategy hinging on the FSF is therefore, in essence, a decentralized process based on informal international understandings which are to be implemented at the level of domestic jurisdictions (Giovanoli, 2000). Let us look at it in greater detail, distinguishing its three fundamental components: standards, governance, and incentives.

The standards. Standard setting is a time-honored international activity. Many specialized standard setting bodies are already active in the world, from the IOSCO (the grouping of securities regulators) to the IAIS (insurance regulators), and beyond (see Giovanoli, 2000, for a comprehensive list). The purpose of the FSF in this field is to collect, endorse, and diffuse their products so as to ensure a speedier and fuller compliance. The first act of the FSF has been the compilation of a comprehensive Compendium of Standards, comprising at present some 60 (check) sets of standards relevant to international financial stability. Among these, the FSF has identified 12 sets of standards as key for sound financial systems and which therefore deserve priority implementation (Table 4). These standards, it ought to be noted, all represent minimum requirements for good practice. As can be seen from the table, even this restricted list is fairly comprehensive in coverage, its items ranging from the various branches of financial supervision to the individual components of market infrastructure. Notably, the standards included in the list are all based on the assumption, left implicit, that the country possesses a predictable legal system, and dependable rules for political accountability- a point I will come back later on.

The area of standard setting, however, does not exhaust, as mentioned above, the activities of the FSF. Under the "vulnerability" heading, the FSF has so far published three reports, respectively on highly leveraged institutions, capital flows, and offshore financial centers. For our purposes, the latter is of particular importance, because it represents the first attempt of the official community to come to grips with a major gap in the present regulatory net, namely the existence of financial centers which derive their attractiveness to investors and financial intermediaries from having lower taxes and laxer regulatory requirements. Consistently with its purpose, the FSF report, published in ..., included a tripartite list of offshore centers, with individual centers being classified according to the quality of their regulatory framework. Not surprisingly, the publication of the list was met with considerable uproar.

Judging the quality of standards is no easy task, since the specificity and degree of precision of international standards may and does vary considerably. If the standard is to be implemented through national legislation in an unambiguous and legally-enforceable way, the more precise the recommendation, the better. However, it is often equally important to have countries accept rather general principles, such as, under the Lamfalussy standards developed for payment systems' purposes, that "netting should have a well founded legal basis under all relevant jurisdictions" (Giovanoli, 2000). Moreover, it may be easier to have countries adopt international standards if they are flexible enough to be adapted to local legal traditions. This can be seen as but one aspect of the "legitimacy" problem, to which I now turn.

Governance. For informal cooperation to work, prescriptions emanating from it must first of all be perceived as legitimate by their recipients. International cooperation in the financial domain started off in the 1960s with the creation of the G10, to which the G7 was added in the course of the 1980s. At first, the G7 confined itself to issues of greater political momentum, such as exchange rate coordination. During the 1990s, with the eruption of a series of currency and financial crises, the division of labor between the two fora became increasingly blurred. It was soon realized, however, that the goal of fostering the adoption of sound regulatory policies throughout the world could not be achieved by simply re-establishing the primacy of the G10 in financial matters. Emerging markets had at least to some extent to be co-opted in the process. The problem was: just to what extent?

One may see this as a genuinely political problem (the desire of the powerful not to dilute too much their power by sharing it with too many new-comers) but this would be only part of the story. The fact is that informal processes, such as the Basel process or the soft law approach now being pursued, work out of consensus. As Bill White, the BIS' chief economist, has put it (White, 2000):

"The fact that the size of the committees is relatively small facilitates the decision making process, so does the tradition of making decisions by consensus. The recognition that a failure to reach international agreement would open the door to both unfair competition and regulatory arbitrage also drives the process forward [...].The issue is how to reconcile an expansion with the maintenance of the intimate club-like atmosphere (also involving shared values and shared conceptual frameworks) that facilitates agreement and decision making on the basis of consensus".

This concern notwithstanding, some expansion in the membership of the main fora was simply inevitable to increase the chances of success of the process. Through enlarged participation, the concern that a particular group of countries wanted to impose its own standards would be mitigated. Moreover, one could expect less resistance from national parliaments, which are typically involved only at a late stage in the process, at the crucial phase of the translation into national law. The first move towards expanded membership occurred in the aftermath of the Mexican crisis, with the establishment of the New Arrangements to Borrow, which saw the participation of 25 countries, selected on the basis of their potential ability to contribute to international rescue packages. The next move came after the Asian crises, with the temporary establishment of the Willard group, which was obtained by adding 15 systemically-significant emerging market economies to the G7. Why the work of the Willard group was in progress, its membership was further extended, first to 26 and then to 33 countries. Since the group was supposed to be temporary, however, this did not make too much of a difference. When the dust of the Asian crises finally settled, in the course of 1999, the G7 took the twofold initiative of setting up both the FSF, which as already mentioned comprises, in addition to the G7, four internationally significant financial centers, and the Group of Twenty, a brand-new grouping comprising, besides the G7 itself, the main emerging market countries (see Table 5 for the composition of the various "Gs", as well as of the FSF). The G20, which gathers once a year at the level of ministers and governors and twice a year at the level of deputies, is supposed to be a broader forum for informal discussion on monitoring risks in the international financial system. In terms of IMF quotas, G20 countries represent about 62 per cent of the total; 17 out of 24 IMF constituencies are represented, which assures the G20 about 74 per cent of the total voting rights within the institution.

Incentives. Standards do not have a legal character, being mere recommendations of international bodies. The essential characteristic of soft law is therefore that it cannot be enforced by legal means. Working through the incentive structure is therefore crucial to ensure its adoption.

In principle, there exist two different sets of incentives for countries to adopt standards: those that flow indirectly from market reactions to lack of observance; and those that result directly from the actions of the official community. In a market-led global economy with decentralized governance, one would expect the first set to provide the stronger mechanism. However, the outreach exercise conducted by the FSF Task Force on Incentives to Foster Implementation of Standard showed that this is not the case. In fact, market participants showed they were not even aware of many of the existing standards. When they were, they declared to place other considerations, such as political risk and economic fundamentals, above regulatory/supervisory risk. One of the most interesting results of the outreach exercise is that:

"Many market participants view the existence of a transparent, predictable, and efficient legal and judicial system as a key precondition for accurate risk assessments, and being of greater importance than the observance of standards. When the legal infrastructure is unreliable - as in some emerging market economies - market participants attach greater importance to conducting due diligence on their individual potential counterparties compared to assessing observance of overall regulatory/supervisory standards".¹⁵

These results may be ascribed to some extent to the novelty of the soft law approach. In due course, market participants may learn to place greater weight to the observance of standards. However, they shouldn't be taken lightly, because they demonstrate that the success of the overall strategy is at present in the hands of the official community itself. Establishing adequate official incentives should therefore be placed at the top of the agenda.

Official incentives may be grouped into three categories: "peer pressure", "name and shame", and "financial incentives". Peer pressure is the traditional mechanism through which, as emphasized by Bill White in the passage cited above, the Basel process works. In the terminology of international relations theory, peer pressure can be expected to work only when countries' authorities already form an "epistemic community", in the sense they share the same world-view and the same appreciation of the gains to be earned from cooperation. If participants are too heterogeneous, or if their national interests diverge substantially, peer pressure will likely be ineffectual.

A somewhat harsher approach goes under the label "name and shame" and consists in pointing to public opprobrium countries or financial centers that do not conform to internationally accepted codes of good behavior. In the past, the official community refrained from resorting to the name and shame approach for fear it could backfire, in that by being too specific on which countries misbehaved could ignite disputes and conflicts among the enforcers themselves, which might have either an economic or a geo-political interest in seeing this or that country not included in the list. More recently, however, the tool has come to be more frequently used. Three notable examples are the publication by the Financial Action Task Force instituted by the G7 to combat money laundering of a list of jurisdictions, graded according to their degree of willingness to cooperate with international authorities concerned about money laundering, the OECD's list of jurisdictions considered to be tax havens, and the FSF's initiative concerning offshore financial centers, already mentioned above. These initiatives, however, are too recent to assess whether they could be sustained in the medium- long-run so as to yield the fruits they are intended to.

Mid-way between peer pressure and name and shame there lies the institutionalized surveillance of international financial institutions. In the course of 1999, the World Bank and the IMF jointly launched two new surveillance tools. The first, named Reports on the Observance of Standards and Codes (ROSCs) is meant to provide a summary assessment of member countries' observance of selected international standards. The second, more comprehensive and also more demanding in terms of time and resources, is the Financial Sector Assessment Program (FSAP), intended to: a) identify strengths, vulnerabilities and risks to the financial systems; b) determine how key sources of risks and vulnerabilities are being managed; c) ascertain the sectors' developmental and technical assistance needs; d) prioritize policy responses. Since its launch, three rounds of experimental ROSCs, regarding 32 developing, emerging market, transition, and industrial economies, have been carried out. In the case of FSAPs, a pilot study of 12 countries has been completed, and 24 more are now in the process of being selected and assessed.

¹⁵ Report of the FSF Follow-up Group on Incentives to Foster Implementation of Standards, September 2000, p.6.

ROSCs and FSAPs fall mid-way between peer pressure and name and shame because, while certainly being based on an in-depth analysis of the individual countries' conditions - which is not typical of peer pressure in its pure form - their circulation remains for the time being confined to official circles. This restriction was necessary to convince countries - which feared the adverse reactions that might descend from publication and which also cared for the confidential information that might be contained in the reports - to subject themselves voluntarily to the exercise. More coercive action was in fact precluded by the lack of authority of the IFIs in the field of financial surveillance.

As to "financial incentives", the most obvious is the inclusion of observance of regulatory and supervisory standards in IMF conditionality. This is something the IMF to a certain extent already does. Ever since the early 1980, so-called structural conditionality in IMF programs has expanded significantly. From the most recent review conducted by the IMF staff, it turns out that about a quarter of structural conditions pertain to the financial system (IMF, 2001). There are two problems with IMF conditionality. First, it can be expected to be effective only if countries need IMF resources, namely if they do borrow. Second, in recent years, the IMF has been subjected to heavy pressure from outside to reduce the scope and weight of structural conditionality in its programs. I will come back to both these problems in Section 4.3.

An even more direct approach would consist in assigning to well-behaved countries a more favorable risk weighting in connection with capital requirements. A harsher measure still could be linking implementation of standards to market access decision or to the degree of supervision of foreign subsidiaries and branches. Actions of this type, while potentially highly effective in principle, have two drawbacks. They may lead to too much bureaucratic intermingling with what should remain to the greatest possible extent "objective", neutral, decisions. Moreover, they would require sustained consensus on the part of international community on what would constitute a measure of "acceptable" compliance, as well as more organized and flexible activities for monitoring the progresses and lapses of the various countries. Overall, it seems unlikely that such a tool will be given much weight in the international community's panoply in the foreseeable future.

4. Beyond Soft Law

4.1 A Missing Set of Players

The soft law strategy is silent on which structure of the financial sector would best serve the strategy's aims, and rightly so, since there is no such a thing as an "ideal" financial structure. Yet, there is ground to believe that a significant presence of foreign-owned financial institutions should be considered as a pre-condition to a rapid transition to truly market-augmenting financial regulation. To be sure, this pre-condition has already been met in a number of emerging markets thanks to a dramatic increase in foreign participation during the second half of the 1990s. For example, in Central Europe the proportion of total bank assets controlled by foreign-owned banks rose from 8 percent in 1994 to 56 per cent in 1999 (Table 6). About one half of total bank assets is by now also controlled by foreign institutions in some important countries of Latin America, such as Argentina, Chile and Peru. But trends are not uniform across regions. As the Table shows, foreign banks play a much smaller role in a number of countries in Latin America and Eastern Europe, as well as in the whole Asian region. This disparity reflects to a large extent official policies that have limited entry, especially into local retail banking markets.

Advocates of greater foreign participation in local markets often point out that competitive pressures created by the entry of foreign institutions will lead to improvements in the banking system's operational and allocative efficiency. But if this were the whole story, authorities in those

countries that resisted foreign participation should at least be granted the benefit of the doubt, as the effects of foreign entry on the efficiency and even the stability of the overall banking system are, on the basis of the available evidence, at least debatable (IMF, 2001). In fact, a pattern recurring in many countries points to foreign entrants “cherry picking” the most profitable domestic markets and customers. In the short-run, this may leave domestic banks with unaltered, and possibly higher, operational costs, and a riskier portfolio, as the less risky client migrate to the new entrants. Since operational costs tend to be sticky, if the authorities do not take immediate action to step up supervisory pressure on local banks, the incentive for the latter “to gamble for resurrection” may prove irresistible. This pattern, it ought to be remarked, had been observed in the aftermath of financial liberalization also in industrial countries.¹⁶

The benefits of foreign entry are probably more subtle, though also less tangible in the short-run. They may come in two forms. First, foreign banks may provide a safe haven for domestic depositors during a confidence crisis, if foreign banks are perceived to be sounder as falling under the protection of either the parent bank (in case of a subsidiary) or of the home headquarters (in case of branch). For example, the market share of deposits in foreign banks tripled in Korea and Indonesia between January 1997 and July 1998. Less prominent, yet perceptible effects of this type have been observed over the years also in other countries, such as Argentina, Thailand, Mexico, and Hungary (IMF, 2001). Through this mechanism, the stability of the overall stock of deposits may be enhanced and the link between bank and currency crises, which produced so much harm in the recent spate of crises, weakened.¹⁷ Second, by “importing” foreign banks emerging markets may end up importing also higher quality supervision. This would occur both directly, since foreign branches and local subsidiaries of international banks are, under the terms of the Basle Concordat, supervised on a consolidated basis with the parent institutions; and indirectly, through the incentive the home supervisor would have to exert pressure on its local peers to upgrade the quality of the host country’s supervisory process.

One might object that the misadventures of Bank of Credit and Commerce International (BCCI) and of Peregrine Investments do not augur well for this mechanism, but the conclusion would probably be overdrawn. As mentioned in Section 2.3, among the lasting consequences of those experiences there is a greater emphasis, within the framework of international financial cooperation, on explicit regulatory actions meant to sanction institutional inadequacies in other countries. For example, a *host* jurisdiction can take into account in deciding whether, and if so under what conditions, it will allow a foreign institution to operate in its markets, the degree to which that institution’s home jurisdiction observes relevant standard. Conversely, a *home* jurisdiction could place restrictions on its domestic financial institutions’ operations in foreign jurisdictions with material gaps in observance of relevant standards. These tools have already been used, most notably within the FSF’s initiative towards off-shore centers, and the results are on the whole encouraging. Moreover, once foreign banks are well established in local markets, it will be in the interest of the home regulator to provide technical assistance for “institutional building” purposes. This mechanism has been particularly prominent in Europe in recent years, with many central banks, securities regulators, and the EU Commission itself *de facto* competing among themselves to provide advisory services to the authorities of accession countries and of Central and Eastern European countries at large. These efforts may take a while to come to full fruition, as by their very nature institution-building processes are long and complex. Meanwhile, they may come under attack, as local interest groups opposed to competition coalesce to stop them. But the very fact that in no country that has been hit by a major crisis in recent years was the process reversed,

¹⁶ See for example Faini, Galli, and Giannini (1992) for a review of the Italian experience with financial liberalization in the Mezzogiorno.

¹⁷ This stabilizing effect lies in stark contrast with the notorious volatility of interbank international lending, one of the aggravating factors in many financial crises of the last decade.

and that several countries have liberalized entry norms for foreign banks after the crisis, testifies to the perceived benefits, in the eyes of local taxpayer, greater cross border competition in banking entails.¹⁸

4.2 A Missing Pillar

Crisis management provides the true test of market-augmenting government. It is only under stress conditions that one can tell the difference between discretionary but accountable and arbitrary actions. Yet, crisis management figures only marginally in the strategy of the official community to address the problem of financial instability in emerging market countries. Among the 12 core sets of standards identified by the FSF, as we have seen, one finds bankruptcy standards. Work in this area is underway at the World Bank, but with the focus falling on corporate insolvency regimes, only. As to bank insolvency, the only reference appears in the IMF Code on Transparency of Monetary and Financial Policy, another item in the list of core standards, which mentions the need for *ex post* disclosure of aggregate emergency lending (para. 7.3.1). This is about all, so far.

The gap is regrettable, since bank crises are likely to remain a permanent feature of the financial landscape – if competition is to be taken seriously. Moreover, opening local banking markets to foreign institutions, for all its merits, is likely to make life harder for the crisis manager for at least some time. In the long- run, as argued in World Bank (2001), greater foreign bank participation may actually prove a stabilizing factor. In the short run, however, the downward pressure on profit margins produced by the appearance on stage of new competitors increases the likelihood of “gambling for resurrection” strategies on the part of those domestic banks that are already on the brink of bankruptcy. Whether this risk will materialize depends among other things on the quality of prudential supervision, which, however, cannot be taken for granted in many emerging markets. Moreover, there is indeed empirical evidence that local subsidiaries of foreign banks tend to react in turbulent times in such a way as to aggravate an incipient crisis (IMF, 2001). As pointed out by Garber (1998), risk-control programs at corporate headquarters may require the foreign subsidiary to cut off liquidity lending to domestic banks during a crisis, or even to withdraw from the retail lending market - a behavior facilitated by the fact that relationship lending is typically less important for foreign banks than for local intermediaries.

Thus, there is reason to believe that crisis management will come under increasing pressures in the years to come. There are two objective difficulties in including crisis management into the overall strategy, though. First, the constructive ambiguity regime rests on the assumption that a cookbook approach to problems in financial markets is likely to be inefficient. Second, present practices in industrial countries differ in important respects, from collateral rules, to willingness to provide central bank funds to banks in distress, to the role assigned to private banks themselves, or in some countries to the deposit insurance scheme, within the crisis management framework (Prati and Schinasi, 1999). But neither difficulty appears insurmountable. Constructive ambiguity, as I have argued in Section 2.3, is not tantamount to “anything goes”. It presupposes a well-designed supportive institutional structure, with legal tools, financial levers, and procedures for accountability. Moreover, the similarities among industrial countries are clearly more numerous than the differences, so that there is a common ground on which to build.

¹⁸ Malaysia is the only country that took no major liberalizing step in the aftermath of the Asian 1997-98 crises. However, foreign bank participation in Malaysia already stood at the time at about 23 percent, one of the highest in the region (IMF, 2001).

A first common element is that crisis management tools are almost everywhere embedded in a body of legal rules especially designed to deal with bank distress. A key distinction in this regard is between judicial and administrative procedures. Non-financial bankruptcy proceedings fall in the former category, bank insolvency proceedings usually in the latter. There are three main differences between the two forms:

- the role of the judicial authorities. In judicial proceedings, the judge performs functions of supervision, guidance and dispute resolution; in administrative proceedings, the judge is entrusted only with the latter, since management supervision and guidance are entrusted to an independent authority;
- the procedures for initiating and pursuing proceedings: judicial proceedings are generally initiated and pursued on the initiative of the debtor or creditors; administrative proceedings are instead typically activated by the competent authority *ex officio*;
- starting requirements: judicial proceedings deal solely with economic crises (insolvency or financial difficulties); administrative proceedings are also meant to address management pathologies (management irregularities or violations of laws or regulations).

Dissatisfaction with the performance of regulatory authorities in emerging markets and the silence on the matter by the international community are leading the IMF staff to disregard the distinction, in favor of greater reliance on strict closure rules for banks (Lindgren, Garcia. And Saal, 1996). The rationale of this approach has been phrased in the following terms by He (2000, p. 13):

“Developing and transition economies [...] do not yet have a mature governance structure with checks and balances well established in the political system, and central banks are often under political pressure toward regulatory forbearance. A rule-based approach makes it easier to judge the appropriateness of the authorities’ actions. In addition, in these economies, central banks as well as market participants have less experience in handling banking problems, and a rule-based approach is technically less challenging to implement”

There is a potential flaw in this approach, however. Regulatory failures in emerging markets can hardly be denied. But can this be used as an argument in favor of a *specific* institutional framework, which moreover requires even more credibility on the part of the regulators themselves? I think this point can be well illustrated with reference to a recent empirical study by Honohan and Klingebiel (2000), who find that resolution costs associated with banking crises tend to be greater, the longer resolution is delayed. The authors interpret their finding as supporting strict closure rules, but this interpretation is questionable. Countries would certainly have benefited from firmer and earlier action. But the real question to be asked is whether they would have been better off had strict closure rules been in place. The latter, however, cannot be taken for granted. In fact, the history of financial regulation shows that a weak institutional environment will equally undermine the credibility of whatever rule designed to avoid political tampering. Implementing the rule will inevitably involve judgment at every step, from measuring bank capital, to assessing the quality of the banks’ loan portfolio, and beyond. One could even argue that the adoption of an apparently stricter approach could make countries worse off, if authorities were thus lulled into taking a laxer approach to crisis prevention.¹⁹ The ultimate effect on the probability of a crisis

¹⁹ This point is implicitly acknowledged by Honohan and Klingebiel (2000) themselves, who remark that their analysis may wrongly attribute to crisis management faults that really belong with crisis prevention. The two functions, it turns out, are inextricably connected.

would at least be ambiguous. I therefore believe that it would be dangerous if the IMF were to send around the message that there are quick-fixes to institutional failures in emerging-market countries.

But if the viability of a strict set of closure rules could be taken for granted, would the argument stand closer inspection? I think not. As Goldstein and Turner (1996) point out, such rules may force the closure of some banks that would have become viable later: there are costs in acting too early as well as too late.²⁰ With hindsight, many would now concord that the abrupt closure of 16 banks in the midst of the Indonesian crisis of 1997, whose immediate effect was that of reinforcing depositors' fears and thereby aggravating the crisis, marked the low point in the IMF's handling of the Asian crises. In fact, the evidence we have for industrial countries shows that outright liquidation has not been the typical regulatory response to bank crises. In their survey of 104 crisis episodes, Goodhart and Schoenmaker (1995) find that in less than one third of the cases was the bank liquidated; the most common response was a take-over by another bank, in many cases with the encouragement, or even the financial assistance, of the authorities. In all other cases, various types of rescue packages, depending on the extension of the crisis and local institutional practices, was mounted. Table 7, which refers to the Italian experience from 1980 onwards, can be taken as fairly representative of present practices in industrial countries. Between 1980 and 2000, there have been in Italy 121 cases of bank distress for which "special administration" has been invoked.²¹ About 30 per cent of the cases ended with the bank returning to ordinary administration and the appointment of new governing bodies, 42 per cent resulted in mergers, and 24 per cent led to the bank being placed in compulsory administrative liquidation. Even when the latter was the final choice, however, the assets and liabilities of the failed bank were transferred as a whole to another bank except in two cases.

Interestingly, the distribution of outcomes changed between the 1980s and the 1990s, a further indication that regulatory practices must also be sensitive to market trends. The proportion of mergers rose between the two decades from 29 to 51 per cent, and that of compulsory administrative liquidation from 17 to 29 per cent. As a consequence, the incidence of banks returning to ordinary administration fell from 55 to 20 per cent.

Pressures to avoid too hasty closure of banks will be even stronger in emerging-market countries, and not only for sheer political reasons. This point has been forcefully made by Stiglitz (2000) with reference to non-financial firms, but the argument can be applied to banks as well:

"It is much easier to destroy firms than to create them. I can very easily tell you how to put all the firms in the economy into bankruptcy. I cannot tell you, having put them into bankruptcy, how to create a million firms in a year. Alas, when firms go bankrupt, there is a destruction of the most important capital in an economy, which is its informational and organizational capital. This entails a real hysteresis effect: once that capital is destroyed it cannot be easily recreated. Then we need to be very risk-averse to take actions that might lead to the destruction of that informational and organizational capital."

²⁰ In this regard, Goldstein and Turner (1996) remark that whereas regulatory forbearance probably contributed to amplify the US saving and loan crisis, it also smoothed the resolution of the debt crisis in developing countries in the 1980s.

²¹ The Italian Banking Law provides for two crisis procedures: special administration and compulsory administrative liquidation. Special administration involves the appointment by the Bank of Italy of one or more special administrators, who replace the distressed bank's management and take over running the company, with all the functions and powers attributed to its former directors. The purpose of the procedure is to ascertain the real situation of the bank, eliminate the irregularities and foster solutions in the interest of depositors. Compulsory administrative liquidation is ordered when the crisis is irreversible or there are exceptionally serious administrative irregularities or violations of legislation or bylaws.

This problem is a real one, and no simple rule will ever dispose of it. Its existence only means, as pointed out by Hart (2000), that bankruptcy reform should not be seen in isolation. It should rather be combined with legal and institutional reforms aimed at protecting the bankruptcy system itself from arbitrary interference. This is the second area where the experience of industrial countries does have lessons for the emerging market countries. The regulatory agency must have the ability to close a bank and to replace the management of an ailing institution, even if the latter is not eventually closed down and liquidated. Moreover, regulators must have adequate protection against personal lawsuits, including those brought by aggrieved owners of the banks being regulated (Caprio and Honohan, 1999). By contrast, a World Bank's recent report shows that supervisors in many countries face a "balance of terror" that biases them in favor of excessive forbearance. In several countries well into the middle income range – Argentina, the Philippines and, until recently, Turkey among them – supervisors can be sued for their actions and be held personally liable, so that they face a very real penalty for whatever vigorous action they might undertake towards supervised entities. Also, there are often no prohibitions for supervisors moving to work, usually at much higher salaries, for the banks they previously supervised, and so on (World Bank, 2001). Under such conditions, it is not surprising that forbearance should be the rule rather than the exception. As Allen *et al* (1938) go at great pain to show, one of the main preoccupations of the legislation of the 1930s was striking the right balance between political accountability and technical autonomy. We now tend to associate the notion of central bank autonomy, or independence, mainly with monetary policy, but it was in the area of banking policy, back in the 1930s, that the need for a competent and autonomous technical agency was first felt (Goodhart, 1988).

Emerging market countries are often in the same situation as were most industrial countries after World War I, with a banking system that has grown rapidly over past years, a history of heavy government interference in financial matters, and an underdeveloped institutional apparatus. This also means that entrusting the role of crisis manager to the central bank rather than to a newly-designed agency should prove in most cases the preferred option. Whatever merit the idea of separating central banking from bank supervision might have, it derives from there being in the country concerned a well-established tradition for market-augmenting government (Goodhart and Shoenmaker, 1995). Where this tradition is lacking, the central bank, with its financial autonomy, greater visibility in the markets, and the independence it usually enjoys for monetary policy purposes, is better placed to assure competence and rigor, provided there exists supportive legislation and clear accountability procedures.

A final area where the experience of industrial countries can provide guidance is deposit insurance. Within a well-specified crisis management framework, an explicit deposit insurance system may enable the crisis manager to provide both a quicker and more effective response to bank distress. One advantage of an explicit scheme is that it can be designed so that the potential costs can be met by levies on bank deposits, perhaps graduated according to the riskiness of the bank, and not by government. Explicit schemes may also make it easier to close a bank by obviating the need for expensive litigation with small depositors. In some countries, like Italy and Belgium, the deposit insurance scheme has also played a useful coordinating role for crisis management purposes, by providing a readily available channel for mustering the financial support of private banks to rescue operations.

4.3 A Missing Roof?

So far I have pointed out two missing elements in the soft law strategy. But a more worrisome weakness regards the fact that the purposes the strategy is intended to achieve are

nowhere explicitly recognized and endorsed by the international community. As is well known, the IMF's Articles of Agreement, which represent the basic international treaty from which the IMF draws its power and legitimacy, do not mention either financial stability or the liberalization of capital transactions among its purposes. The only reference to capital flows occurs in Article IV, which mentions as the essential purpose of the international monetary system "to provide a framework that facilitates the exchange of goods, services, and capital among countries". But, it ought to be emphasized, this is not mentioned *as a purpose of the IMF*, and in fact, on the one hand, there is no mention of it in Article I, which is really the central pillar of the whole architecture; on the other, the language in Article IV coexists with other provisions, especially those of Article VI on the legitimacy of capital controls, which point in the opposite direction.

One might deem that statutory gaps are not much of a hindrance. After all, financial stability and capital convertibility have already found their way into the IMF's daily activity, especially as regards conditionality and surveillance. So, why bother?

Well, the crux of the matter is that it may not prove particularly hard to maintain consensus when the task simply consists in making operational principles that are well specified at the level of the overall framework. It is quite another matter, however, to reach and sustain consensus about principles that are nowhere clearly stated, or, worse, that lie in stark contrast with an organization's basic mandate. The latter situation is closer to reality than the former. The soft law strategy is an attempt to expand the code of conduct to embrace financial stability within a framework, that of the IMF Articles of Agreement, which was designed for a world which featured capital controls and financial repression as permanent components.

This state of affairs, moreover, is likely to prove a continuous source of strain also for another reason. The task at hand, promoting capital account liberalization in a context that safeguards to the greatest possible extent financial stability, entails greater pressure on emerging market countries than on industrial countries, and may be challenged as an infringement of the sacred principles of universality (or parity of treatment) and reciprocity, on which the IMF has been founded. It would seem a weak argument, since as Goldstein (2001) has aptly remarked

"it is not realistic to expect a developing country that gets into a crisis to live by the same structural policy conditionality as would a troubled industrial country. For the foreseeable future, developing countries will have to contend with a history of banking debt, and currency crises, and restoration of confidence will often require a different dose and mix of macroeconomic and structural policies than would be the case for industrial countries"(p. 11).

Yet, the argument is often heard, and is having an impact at least two levels. First, it lies behind both the voluntary nature of ROSCs and FSAPs, namely the two main forms through which financial surveillance is taking place, and the heavy reliance on self-assessments within these exercises.²² Second, it is the centerpiece of the criticism of structural conditionality. Over the years, the IMF has responded to the increasing concerns with poor governance by developing structural conditionality, aimed at reducing government-imposed distortions or putting in place various institutional features of a modern market economy. In a nutshell, structural conditionality aims at promoting market-augmenting government. As it turns out, about two-thirds of structural conditions are concentrated in the areas of financial sector policies, tax and expenditure reforms, and public enterprises and privatization. The most frequent charges brought against structural conditionality are that it has resulted in the IMF straying without a clear mandate from its core

²² Incidentally, it is also responsible for the fact that a considerable amount of the IMF's scarce resources are now being devoted to carrying out detailed surveillance exercises on the financial sectors of industrial countries.

competence of macroeconomic and exchange rate policies, that it leads to unequal treatment of member countries, and that if too many structural conditions are imposed, countries will tend to wait to resort to the IMF until problems become even less manageable (see Goldstein, 2001 for a comprehensive survey of these arguments). As a result, the IMF is now in the process of “streamlining” conditionality, a task that has been endorsed by the international community at the 2001 Spring Meetings.

Streamlining is always a good idea, provided the purposes are clear. One may be justified in criticizing the IMF for the number of structural conditions it imposes, or for some specific conditions that may have proved ill-advised. I mentioned in the previous Section several structural conditions pertaining to crisis management that may have had the unintended effect of aggravating the crisis they were meant to cure. But concluding from this that the very notion of structural conditionality is ill-advised, or that its scope should be substantially reduced, would be quite a long jump. Indeed, the main theme throughout these pages is that the globalization of finance presupposes a much broader focus for international cooperation than it used to be the case. If countries could be trusted to put in place appropriate regulation and supervision by themselves, there would be little need for coordination. Both history and reflection suggest that this is not going to happen. Structural conditionality and financial surveillance therefore deserve high prominence.

So, the real question is: what can be done to upgrade the overall framework at the level of principles?

One obvious solution would be to amend the IMF Articles of Agreement so as to endorse capital account convertibility and sound financial regulation among its goals. This is an old theme in international financial cooperation, having surfaced for the first time in the late 1970s, in the context of the Second Revision of the Articles. At the time, though explored at great length, the idea failed to win sufficient support (Crawford Lichtenstein, 2000). When it resurfaced, in 1996-97, the international community got very close to reaching consensus on the desirability of capital account convertibility. At its meeting on April 1997, the Interim Committee of the IMF (now renamed International Monetary and Financial Committee) agreed “*that the Fund’s Articles should be amended to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements*”.

Negotiations to this end however stopped in the aftermath of the Asian crises, and have not yet resumed. There are two main arguments against capital account liberalization. The first, well epitomized by Rodrik (1998) is that financial stability is a permanent feature of modern financial markets, so that in principle it is not clear why capital convertibility should be preferable to capital controls. The analogy between the benefits of free trade and those of free capital mobility simply does not stand close scrutiny.

This argument, however, does not seem compelling. One may believe in the inherent instability of banking and yet believe that judicious progress towards capital convertibility may be instrumental in fostering the upgrading financial regulation and supervision, and thereby in attenuating the real impact of financial instability. After all, there have been banking crises in industrial countries, too, but their fiscal and output costs have been comparatively low, nor have they generated pressure to reverse the considerable progress made over the last two decades in financial opening. The main lesson of the industrial countries’ experience is that countries opening their capital account should strengthen the capital base of their financial institutions and improve prudential supervision - and that there is probably a causal link between the former and the latter. To put it bluntly, enlightened capital convertibility is surely preferable in the long run to financial isolationism. The real problem is how to get there.

The second objection to capital convertibility is more technical in nature, but probably also better founded. It became clear in the course of the discussions on a possible amendment that the framework that had been devised to promote current account convertibility would not have been appropriate for capital transactions. In the former case, it was only the payments related to current transactions that had been liberalized, with states retaining the right to intervene as they saw fit in the relevant domestic markets. In the latter, given the nature of financial exchanges, one should instead envisage also the liberalization of the underlying transactions. Otherwise, any country would remain free, even if complying with a mandatory liberalization of international payments, to forbid the non-resident from purchasing domestic securities or, for that matter, to forbid residents to sell securities to non-residents. Any attempt “to give jurisdiction”, as the Interim Committee’s statement recites, to a multilateral agency on such matters would therefore amount to depriving member states of a considerable part of their sovereignty, and may conflict with other legitimate domestic policy concerns.

This objection is hard to dismiss, and may be deemed to be the real cause of the present stalemate. But it really concerns the method, rather than the purpose. As Polak (1998), a staunch opponent of the idea of IMF’s “jurisdiction” over capital transactions has remarked, there is really no need to make capital account convertibility mandatory and externally enforced. What one needs is a clearer recognition of the substantive benefits that member countries would derive from greater freedom for capital movements. To achieve this, there is no need to modify Article VIII. It would suffice to add capital account convertibility to the purposes listed in Article I and perhaps remove the provisions of Article VI, inspired by a by now obsolete philosophy. In this way, as Polak (1998, p. 52) wisely argues

“not burdened with the legal task [of being the enforcer of the new legal code], the IMF staff can be the unbiased adviser of member countries on the benefits and costs of capital liberalization and a reliable source of information about best practices in this field.”

The “soft” method Polak is proposing resembles the “middle position” emerged in the course of the 1970s, when capital account convertibility was first contemplated. It consisted in leaving to national authorities responsibility for regulating their financial systems while asking them to endorse the benefits of capital mobility and to reach international agreement “on the coordination of policies that would mitigate the undesirable effects of capital flows” (Gold, 1977).

It is also reminiscent of the approach followed in Europe to achieve intra-regional capital account convertibility. As recalled in Section 2, the principle of capital account liberalization was endorsed as far back as 1957, being enshrined in the Treaty of Rome. About twenty years elapsed before the principle could be translated into concrete acts, with the first Banking Directive. But the real watershed in European financial integration occurred in 1985, when it was realized that an integrated market for financial services would not require harmonization of all the applicable regulations, provided the participating countries could be trusted to have an appropriate market-augmenting system of government intervention. A “softer” method was called for. It was eventually found in the single passport strategy, hinging on the three pillars of mutual recognition, home country control and minimum standards. It was in essence a way of reconciling the need for harmonized rules with the national embeddedness of the safety-net (or “ownership”, in current IMF jargon). Its effectiveness can be appreciated from two facts. As early as July 1990, capital liberalization had already been completed, with capital restrictions being effectively abolished in 8 out of 12 member states. Moreover, after the exchange-rate crises of 1992 and 1993 reinstating measures to regulate capital flows was contemplated, but was quickly discarded as an option because of its dubious effectiveness in the new institutional context and its adverse impact on

credibility (Bakker, 1996). By then, capital account convertibility had become to be perceived by authorities and the wider public alike as irreversible.

Three things ought to be noted about the European approach. First, the method followed was probably the key to its success. Standards were turned into legally binding rules through use of the so-called directives, which are legal texts setting the principles member states are required to implement. But member states enjoy wide freedom with regard to the means they select in order to enact those principles, and an appropriate transition period is provided for. Second, monetary union is not a logical prerequisite of successful financial integration. Indeed, the single market for financial services has been realized within a scenario in which monetary union was a far away objective, and on whose feasibility (or even desirability) many in Europe entertained serious doubts (Onado, 2001). Finally, the integration of financial regulation should not be confounded with attempts to facilitate the process of crisis management. The latter, if anything, should be expected to be an outcome of the process, not the first step or the inspiring motive. Thus, the Chang Mai initiative in Asia, which aims at establishing a system of unconditional liquidity swaps among central banks, should be evaluated with caution. What the international community lacks is not the liquidity with which to deal with crises, as recent episodes testify, but rather ways to promote market-augmenting government in such a way as to reduce at once the probability of crises and the fiscal costs of those crises that do break out. Informal schemes for liquidity support are unlikely to be of much help in this regard.

It would be foolish to think that the European approach could be replicated at the world level. The number and economic and institutional diversity of the countries involved are simply too great for the approach to be feasible. But the success of financial integration in Europe testifies at once to the importance of casting the process within a clear canvas, specifying objectives and principles to be shared, as well as a process of gradual institutional adaptation, and to the desirability of a flexible approach, leaving much room to national preferences and traditions. That whatever strategy is to be pursued at the global level, it must be “broad in scope, soft in method”, as the title of this paper has it.

5. Conclusion

Bank defaults are a permanent and even desirable feature of a healthy financial system. What authorities can and should do is prevent instability to the greatest possible extent and then manage actual crises in such a way as to avoid failure of viable institutions, circumscribe contagion effects, and preserve “appropriate” ex ante incentives for creditors, shareholders and managers. This is in essence the lesson industrial countries have learned through a long and complex historical process, which has spanned practically the whole of the twentieth century.

As a result, although bank crises have not disappeared, in the industrial countries their real impact has been brought to manageable proportions. Similarities in the degree of capital mobility notwithstanding, the existence of an articulated and on the whole reliable apparatus presiding over financial stability is what differentiates the present international financial environment from the Gold Standard’s. International cooperation at various levels, if often overlooked in public discourse, has proved crucial in the development of present regulatory and supervisory practices.

It is against this background that I have analyzed the current efforts to extend the coverage of financial regulation and supervision to emerging markets. I have argued, in particular, that the soft law strategy, far from being dictated by a lack of political determination, is an attempt to reconcile the need for harmonization with the equally pressing need for embedding the banking

safety-net into the domestic political and legal environment. On these bases, I have rejected apparently more appealing, but ultimately simplistic approaches, such as the idea of centralizing supervisory authority at the world level or tying IMF lending to a limited and objectively verifiable set of structural criteria. In passing, I have also challenged the currently fashionable view that IMF conditionality needs to be subjected to a thorough rethinking, and its scope severely reduced. If anything, the task now confronting the international community seems to call for a broader compass, embracing institutional aspects, such as legal procedures and accountability rules, that have so far largely been left out of the agenda of international cooperation.

The main limitations of the soft law strategy, I have argued, lie elsewhere. First, in neutral stance as regards the presence of foreign institutions in emerging market countries. A greater foreign participation in the domestic banking systems, even disregarding its allocative and efficiency impact, may prove an important channel for importing better institutions and market practices. Second, in its rather noisy silence on crisis management procedures, which in industrial countries play a key role in the overall safety-net, and have proved a driving force in the development of crisis prevention tools. If bank defaults could be eliminated altogether, this would not be too much of a problem. But since this is neither a feasible nor a desirable goal, it is important to make authorities in emerging market countries aware that some ways of dealing with actual crises may in the long-run prove preferable with respect to others from a welfare perspective. Constructive ambiguity, that is, is not tantamount to “anything goes”. Last, but by no means least, in the lack of a clear commitment to capital account convertibility. There is by now widespread consensus that full capital account liberalization should not be taken as an article of faith. Yet, setting it as a long term goal to be *promoted* rather than *imposed* on individual countries, along the lines suggested by Polak (1998), in the context of a revision of the IMF Articles of Agreement that specified also the circumstances under which a departure from this goal might appear acceptable to the international community, would arguably constitute a significant improvement over present conditions. It would guide market participants’ expectations as well as strengthen the incentives of authorities in emerging markets to work with determination and good faith at upgrading the domestic institutional apparatus, so as to attain a truly market-augmenting financial regulation. This seems to be one of the main lessons to be brought home from the UE’s experience with the Single Market project. It deserves to be recognized and pondered.

TABLE 1
CAPITAL MOBILITY SINCE 1870¹

	Argentina	Australia	Canada	Danimarca	Francia	Germania	Italia	Giappone	Norvegia	Svezia	Gran Bretagna	Stati Uniti	Totale
1870-1889	18,7	8,2	7,0	1,9	2,4	1,7	1,2	0,6	1,6	3,2	4,6	0,7	3,7
1890-1913	6,2	4,1	7,0	2,9	1,3	1,5	1,8	2,4	4,2	2,3	4,6	1,0	3,3
1914-1918	2,7	3,4	3,6	5,1	-	-	11,6	6,8	3,8	6,5	3,1	4,1	(5,1)
1919-1926	4,9	4,2	2,5	1,2	2,8	2,4	4,2	2,1	4,9	2,0	2,7	1,7	3,1
1927-1931	3,7	5,9	2,7	0,7	1,4	2,0	1,5	0,6	2,0	1,8	1,9	0,7	2,1
1932-1939	1,6	1,7	2,6	0,8	1,0	0,6	0,7	1,0	1,1	1,5	1,1	0,4	1,2
1940-1946	4,8	3,5	3,3	2,3	-	-	3,4	1,0	4,9	2,0	7,2	1,1	(3,2)
1947-1959	2,3	3,4	2,3	1,4	1,5	2,0	1,4	1,3	3,1	1,1	1,2	0,6	1,8
1960-1973	1,0	2,3	1,2	1,9	0,6	1,0	2,1	1,0	2,4	0,7	0,8	0,5	1,3
1974-1989	1,9	3,6	1,7	3,2	0,8	2,1	1,3	1,8	5,2	1,5	1,5	1,4	2,2
1989-1996	2,0	4,5	4,0	1,8	0,7	2,7	1,6	2,1	2,9	2,0	2,6	1,2	2,3

SOURCE: Obstfeld and Taylor (1996).

¹ Means Absolute Value of Current Account as a percentage of GDP. Based on annual data. Parentheses denote average with some countries missing.

TABLE 2
THE FISCAL COSTS OF THE MAIN BANKING CRISES, 1980-2001

Country (year or years of crisis)	Estimate of total losses/costs (percentage of GDP)	Country (year or years of crisis)	Estimate of total losses/costs (percentage of GDP)
Latin America		Transition countries	
Argentina (1980-82)	55,1	Bulgaria (1996-97)	13,0
Argentina (1995)	0,5	Czech Republic (1989-91)	12,0
Brazil (1994-96)	13,2	Hungary (1995)	10,0
Chile (1981-83) ¹	41,2	Poland (1992-95)	3,5
Colombia (1982-87)	5,0	Slovenia (1992-94)	14,6
Ecuador (1996)	13,0		
Mexico (1995) ²	19,3	Industrial countries	
Paraguay (1995)	5,1	Australia (1989-92)	1,9
Uruguay (1981-84)	31,2	Finland (1991-94)	11,0
Venezuela (1994-97)	22,0	France (1994-95)	0,7
		France (1996)	1,5
Africa		Italy (1996)	1,0
Benin (1988-90)	17,0	Japan (1990s) ⁵	20,0
Côte d'Ivoire (1988-91)	25,0	New Zealand (1987-90)	1,0
Egypt (1991-95)	0,5	Norway (1987-93)	8,0
Ghana (1982-89)	3,0	Spain (1977-85)	5,6
Mauritania (1984-93)	15,0	Sweden (1991-94)	4,0
Senegal (1988-91)	10,0	Turkey (1982-85)	2,5
Tanzania (1987-95) ³	10,0	Turkey (1994)	1,1
		Turkey (2001)	32,0
Asia		United States (1981-91)	3,2
Indonesia (1992-94)	3,8		
Indonesia (1997)	50,0		
Israel (1977-83) ⁴	30,0		
Malaysia (1985-88)	4,7		
Malaysia (1997)	16,4		
Philippines (1983-87)	13,2		
Philippines (1998)	0,5		
South Korea (1997)	26,5		
Sri Lanka (1989-93)	5,0		
Thailand (1983-87)	2,0		
Thailand (1997)	32,8		

SOURCES: Caprio, G. and D. Klingebiel (1996); Banca d'Italia, *Annual Report* on 1996; Lindgren, Balıño, Enoch, Gulde, Quintyn and Teo (1999).

¹ 1982-85.

² Accumulated losses to date.

³ 1987.

⁴ 1983.

⁵ Estimate of potential losses.

TABLE 3
 REQUIRED AND ACTUAL CAPITAL RATIOS
(In percentages)

	Capital adequacy ratio (national requirements)	Actual risk-based capital ratio (1995)
India	8	9,5 ¹
Hong Kong	8 ²	17,5 ³
Korea	8	9,3
Singapore	12 ⁴	18,7 ⁴
Taiwan	8	12,2
Indonesia	8	11,9
Malaysia	8	11,3
Thailand	8	9,3
Argentina	12	18,5
Brazil	8 ⁵	12,9
Chile	8 ⁶	10,7
Colombia	9	13,5
Mexico	8	11,3
Israel	8	10,5 ⁷
South Africa	8 ⁸	10,1
<i>Memorandum:</i>		
United States	8	12,8
Japan	8	9,1

SOURCE: Goldstein and Turner (1998).

¹ Relates only to public sector banks.

² 12% for some banks; 16% for some non-banks.

³ Relates to locally incorporated authorised institutions and is on a consolidated basis.

⁴ Based only on Tier 1 capital.

⁵ Plus 1,5% on notional value of swap operations.

⁶ Legislation at present before Parliament.

⁷ 1994.

⁸ For some banks, higher ratios.

TABLE 4
KEY STANDARDS FOR SOUND FINANCIAL SYSTEMS

SUBJECT AREA	KEY STANDARDS	ISSUING BODY
<i>Macroeconomic Policy and Data Transparency</i>		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	International Monetary Fund
Fiscal Policy Transparency	Code of Good Practices in Fiscal Transparency	International Monetary Fund
Data dissemination	Special Data Dissemination Standard/ General Data Dissemination System	International Monetary Fund
<i>Institutional and Market Infrastructure</i>		
Insolvency	(in the course of development)	World Bank
Corporate Governance	Principles of Corporate Governance	Organization for Economic Cooperation and Development
Accounting	International Accounting Standards (IAS)	International Accounting Standards Committee
Auditing	International Standards on Auditing (ISA)	International Federation of Accountants
Payment and settlement	Core Principles for Systematically Important Payment System	Committee on Payment and Settlement Systems
Market integrity	The Forty Recommendations of the Financial Action Task Force	Financial Action Task Force
<i>Financial Regulation and Supervision</i>		
Banking Supervision	Core Principles for Effective Banking Supervision	Basel Committee on Banking Supervision
Securities regulation	Objectives and Principles of Securities Regulation	International Organization of Securities Commission
Insurance supervision	Insurance Supervisory Principles	International Association of Insurance Supervisors

SOURCE: Financial Stability Forum.

TABLE 5
COMPOSITION OF THE MAIN FORA FOR INTERNATIONAL COOPERATION

G7	G10	G20	GAB¹	NAB¹	FSF²
Canada France Germany Italy Japan United Kingdom United States	Canada France Germany Italy Japan United Kingdom United States Belgium Netherlands Sweden Switzerland	Canada France Germany Italy Japan United Kingdom United States Australia Korea Saudi Arabia Argentina Brazil China India Indonesia Mexico Russia South Africa Turkey EU Presidency ECB IMF WORLD BANK	Canada France Germany Italy Japan United Kingdom United States Belgium Netherlands Sweden Switzerland Saudi Arabia ³	Canada France Germany Italy Japan United Kingdom United States Belgium Netherlands Sweden Switzerland Australia Korea Saudi Arabia Austria Denmark Finland Hong Kong Kuwait Luxembourg Malaysia Norway Singapore Spain Thailand	Canada France Germany Italy Japan United Kingdom United States Hong Kong Netherlands Singapore IMF WORLD BANK BIS OECD Regulatory Committees ⁴

¹ GAB: General Arrangements to Borrow; NAB: New Arrangements to Borrow. Although not formalized groupings, the GAB and the NAB establish to provide the IMF with exceptional source of financing to deal with crises of systemic nature, represent additional channels for international financial cooperation.

² Financial Stability Forum.

³ Associated agreement.

⁴ Basel Committee on Banking Supervision (BCBS), International Organization of Securities Commission (IOSCO), International Association of Insurance Supervisors (IAIS), Committee on the Global Financial System (CGFS), Committee on Payment and Settlement Systems (CPSS), International Accounting Standards Committee (IASC).

TABLE 6
FOREIGN BANK OWNERSHIP IN SELECTED EMERGING MARKETS ¹

	Total Assets December 1994	Foreign Control ² December 1994	Total Assets ³ December 1999	Foreign Participation December 1999	Foreign Control ² December 1999	Foreign Control ⁴ December 1999
	<i>(In billions of U.S. dollars)</i>	<i>(In percent)</i>	<i>(In billions of U.S. dollars)</i>	<i>(In percent)</i>	<i>(In percent)</i>	<i>(In percent)</i>
Central Europe						
Czech Republic	46,6	5,8	63,4	47,3	49,3	50,7
Hungary	26,8	19,8	32,6	59,5	56,6	80,4
Poland	39,4	2,1	91,1	36,3	52,8	52,8
Total	112,8	7,8	187,1	44,0	52,3	56,9
Turkey	52,0	2,7	156,2	1,6	1,7	1,7
Latin America						
Argentina	73,2	17,9	157,0	41,7	48,6	48,6
Brazil	487,0	8,4	732,3	18,2	16,8	17,7
Chile	41,4	16,3	112,3	48,4	53,6	53,6
Colombia	28,3	6,2	45,3	16,2	17,8	17,8
Mexico	210,2	1,0	204,5	18,6	18,8	18,8
Peru	12,3	6,7	26,3	33,2	33,4	33,4
Venezuela	16,3	0,3	24,7	34,7	41,9	43,9
Total	868,6	7,5	1.302,4	24,2	25,0	25,5
Total excluding Brazil and Mexico	171,4	13,1	365,6	39,5	44,8	44,9
Asia						
Korea	638,0	0,8	642,4	11,2	4,3	16,2
Malaysia	149,7	6,8	220,6	14,4	11,5	11,5
Thailand	192,8	0,5	198,8	6,0	5,6	5,6
Total	980,5	1,6	1.061,8	10,9	6,0	13,2

SOURCE: IMF staff estimates based on data from Fitch IBCA's BankScope Database.

¹ Ownership data reflect changes up to December 1999 while balance sheet data are the most recent available in Fitch IBCA's BankScope.

² Ratio of assets of banks where foreigners own more than 50 percent of total equity to total bank assets.

³ For Central Europe and Asia available balance sheet data are in most cases for December 1998.

⁴ Same as footnote 2 but at 40 percent level.

TABLE 7
SPECIAL ADMINISTRATION PROCEDURES AND THEIR OUTCOME IN ITALY (1980-2000)

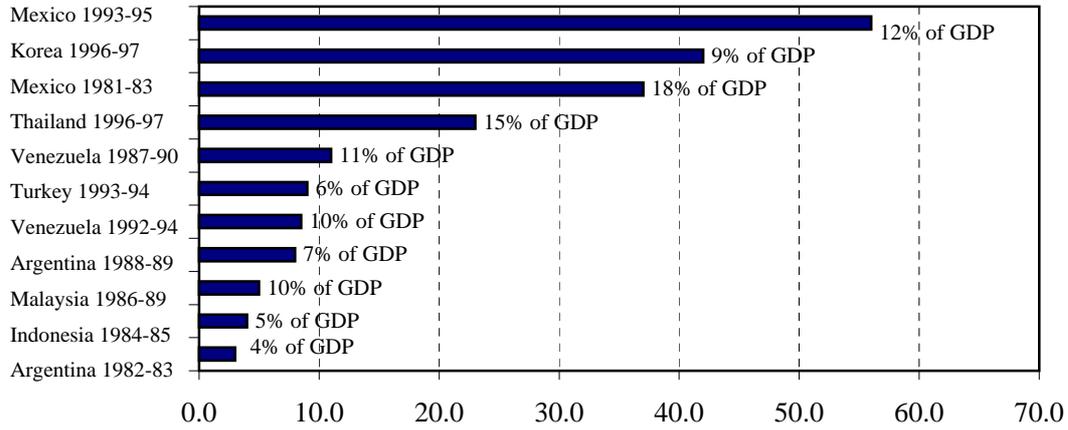
Years	Banks placed in special administration	of wich: returned to ordinary administration	of wich: placed in compulsory administration liquidation	of wich: merged with other banks
1980	4	1	2	1
1981	3	-	-	3
1982	5	2	1	2
1983	3	2	-	1
1984	4	4	-	-
1985	7	5	1	1
1986	4	2	2	-
1987	6	4	-	2
1988	6	3	1	2
1989	5	1	1	3
1990	5	-	1	4
1991	7	1	1	5
1992	5	1	2	2
1993	3	-	2	1
1994	12	6	2	4
1995	7	2	3	2
1996	6	1	3	2
1997	9	-	2	7
1998	5	-	1	4
1999 ¹	8	1	2	1
2000 ²	7	-	2	1
TOTAL	121	36	29	51
% of total	100%	30%	24%	42%

SOURCE: Boccuzzi (1998); Banca d'Italia, *Annual Report* on 1999 and 2000.

¹ One procedure still in effect.

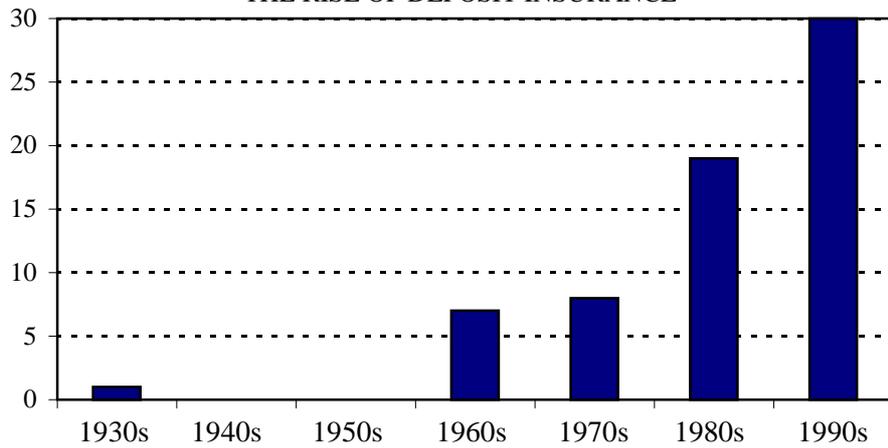
² Four procedures still in effect.

FIGURE 1
 LARGE REVERSALS IN NET PRIVATE CAPITAL FLOWS
 (In billions of US dollars and as percentage of GDP)



SOURCE: Lopez-Mejia (1999).

FIGURE 2
 THE RISE OF DEPOSIT INSURANCE



SOURCE: Garcia (2000).

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