

CHAPTER

1

The International Monetary Fund's Legal Instruments to Promote Financial Stability

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This chapter examines the legal instruments available to the International Monetary Fund to promote financial stability in and among its member countries. The instruments are derived from the Fund's functions under its Articles of Agreement and the manner in which the Fund performs these functions.

The chapter first provides a definition of financial stability. It then turns to the Fund's legal framework, starting with some basic principles and then examining the purposes of the Fund and their relationship to financial stability. The chapter then discusses three important functions of the Fund as they relate to financial stability: surveillance, technical assistance, and financial assistance.

Defining Financial Stability

There is no generally accepted definition of financial stability. Rather, it is an evolving concept and can mean different things in different contexts. A narrow definition would refer only to the stability of a country's banking system, but financial stability cannot be ensured by focusing on a country's banks alone. A country's financial system also includes its payments system and, more broadly, its securities exchanges, pension funds, insurers, and other entities that provide a framework for carrying out economic transactions and channeling savings into investment. A broader definition of financial stability can therefore refer to a concern for stability at all these levels, including the efficient operation of a country's financial markets.

Further, a definition of financial stability can have both a domestic and an international element. It can refer not only to the stability of the domestic financial system but also the stability of the global financial system and avoidance of situations in which a financial or economic crisis in one country has ripple effects that lead to crises in others.

This chapter adopts the broad definition of financial stability. For our purposes, a stable financial system is one in which major shocks that could disrupt the smooth functioning of the financial system are prevented, one which can withstand such shocks when they occur, and one in which such shocks do not spill over into neighboring countries or into other regions of the world.

The Fund's Legal Framework: Basic Principles

To understand the Fund's legal framework and the manner in which it approaches the issue of financial stability, it is important to keep a few principles in mind.

First, the Fund's legal framework is largely an aspect of public international law. Thus the focus of the chapter is not on how member countries promote their domestic financial stability but on the legal framework governing the operations of the International Monetary Fund and the manner in which the Fund interacts with its member countries to promote financial stability.

Second, it is important to keep in mind that the Fund is an international organization established by a multilateral treaty, the Articles of Agreement. The two most important sources of law for the Fund are the Articles of Agreement and decisions of the Executive Board. The Articles specify the purposes of the Fund and certain functions that the Fund is to perform in furtherance of these purposes. The Articles also establish certain obligations that member countries are required to observe, some of which are relevant to the question of financial stability. To make an analogy to a domestic legal system, the Articles of Agreement represents the Fund's constitution.

The second important source of law for our purposes consists of decisions of the Fund's Executive Board. In addition to governing the Fund's day-to-day operations, the Board adopts decisions of general applicability that specify how the Fund will interact with its members on different issues and how specific provisions of the Fund's Articles will be implemented. These decisions of general applicability are roughly analogous to legislation in a domestic legal system.

The Fund's Legal Framework: Purposes

If one looks at the Fund's purposes under Article I of the Fund's Articles of Agreement, one will not see a reference to financial stability. Yet financial stability has become central to the achievement of many of the purposes set out in Article I.

To understand their relationship to financial stability, it is useful to highlight two of these purposes:

- First, "to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation" (Article I (iii));
- Second, "to assist in the establishment of a multilateral system of payments in respect of current transactions and in the elimination of foreign exchange restrictions which hamper the growth of world trade" (Article I (iv)).

Thus if one were to boil the purposes of the Fund down to their essence, it might consist of the following: to build an international monetary system in which current payments and transfers between countries move freely, and the system of exchange rates between the currencies of different members are stable and supported by prudent economic and financial policies implemented by each of the Fund's members. By building a stable international monetary system, the Fund will create the basis upon which global trade and investment will continue to grow and contribute to growth throughout the global economic system.

Viewed from this perspective, the importance of financial stability to the Fund is obvious. It would be impossible for the Fund to ensure the stability of the international monetary system without first ensuring the stability of members' financial systems. A sound financial system in each of its member countries is essential to support macroeconomic stability. Problems in a country's financial system can reduce the effectiveness of monetary policy, create large fiscal costs related to the rescue of troubled financial institutions, trigger capital flight, and deepen economic recession.

Moreover, it would be impossible for the Fund to ensure the stability of the international monetary system without also ensuring that the linkages between the financial markets of different countries are given adequate attention. The globalization of financial markets now means that many issues related to financial stability need to be dealt with at the global level: financial weaknesses in one country can rapidly spill over and contaminate others.

The Fund has learned this lesson from bitter experience. There have been far too many examples of crises in a member country's financial system that have sent shock waves through the member's economy and have triggered a major balance of payments crisis in that country and, in some cases, in others. Clearly, the promotion of financial stability has become closely linked to the purposes of the Fund.

The Fund's Legal Framework: Functions

Insofar as the Articles relate to the promotion of financial stability, the principal functions of the Fund are surveillance, technical assistance, and financial assistance.

Surveillance under Article IV

Surveillance under Article IV is perhaps the Fund's most important function. It is conducted in both the bilateral and multilateral contexts. This section focuses on surveillance at the bilateral level.

Article IV is concerned primarily with the promotion of a stable system of exchange rates among the currencies of all the Fund's members. Member countries are required under Article IV to observe certain obligations respecting their domestic economic and financial policies and their exchange rate policies that are designed to promote orderly exchange arrangements and a stable system of exchange rates. Article IV assumes that if members implement the right macroeconomic policies, stability in the global system of exchange rates will be assured.

With this objective in mind, the Fund is required under Article IV to exercise surveillance over members' compliance with these obligations. While the provisions of Article IV contemplate that the Fund would engage in a compliance exercise with each of its members, in practice it has evolved into a broader exercise. Beyond such questions of compliance, the surveillance process has evolved into a policy dialogue in which the Fund seeks to persuade the authorities of member countries to follow domestic and external policies that will contribute to external stability. On a regular basis (normally annually), the Fund discusses economic developments and policy with the authorities of each of its members and communicates its views to the member on its policies and on those areas that may be a cause for concern.

Three important features of this process should be noted. First, the purpose of surveillance is essentially crisis prevention, to persuade the authorities of a member to change their policies before they may lead to a macroeconomic crisis.

Second, the surveillance process is mandatory and universal in its application. It applies to all of the Fund's members, each one of which is required to participate in the process, to consult with the Fund, and to provide the Fund with the information it needs for this purpose.

Third, given the broad range of policies that could theoretically be relevant to the questions of macroeconomic stability that are at the heart of an Article IV discussion, there is generally some discretion on the part of the Fund as to the particular issues and policies it will raise with a member. Some types of policies are very closely related

to the obligations of members under Article IV and will inevitably be discussed in an Article IV consultation. Other policies may only be important in the circumstances of a particular member and may only be discussed with respect to that member.

How does this relate to financial stability? One area of policy that has been a growing subject of attention in the Article IV process concerns the financial systems of members and their linkages with other members' financial systems. While there was a time when these issues received comparatively little attention in an Article IV consultation, this is no longer the case. The financial sector is now an important area that is frequently discussed with members under Article IV.

As part of its medium-term strategy, the Fund is in the process of implementing several important changes to strengthen its analysis of financial sector issues in the context of bilateral surveillance. It is expected that Article IV reports will incorporate analyses of financial sector and balance sheet vulnerabilities, drawing their implications for macroeconomic aggregates and capital flows, and the scope for domestic and external spillovers. To strengthen the quality of the Fund's financial sector work in the Article IV process, a new department, the Monetary and Capital Markets Department, has been created to focus on these issues and work closely with the Fund's area departments in their surveillance work.

Technical Assistance

As a mechanism for the promotion of financial stability, surveillance has the advantage of its universal application and global reach. Its principal drawback, however, is the level of detail with which it examines the financial sector. Surveillance is concerned with broad macroeconomic policy and developments in a member country. It is not possible for the Fund to examine the member's financial sector in great detail in this process. This is where the Fund's second mechanism for the promotion of financial stability, technical assistance (TA), comes into play.

Under Article IV, Section 2(b), the Fund may perform financial and technical services for members. These technical services

generally take the form of expert advice that the Fund provides to its members to help them strengthen their institutional capacity in areas of importance to the Fund. TA is voluntary, both for the member and for the Fund. The Fund is not required to provide it, and will only do so if a member requests it.

In the area of financial stability, the Fund has an active TA program that is focused primarily on the institutional capacity of member countries in the financial sector. Fund staff works closely with the authorities of member countries, in particular to help them to strengthen the organizational structure and operations of their central banks and financial supervisory agencies and to transfer know-how, on, for example, the conduct of monetary policy and other central bank operations, and the supervision of financial institutions and payments systems.

The Fund's Legal Department provides legal technical assistance to member countries on issues related to the financial sector. The Department has a very active program of assistance in legislative drafting in the financial sector and in training lawyers and judges in member countries in principles of financial law and in international best practices in these areas.

Financial Sector Assessment Program

A particularly important component of the Fund's TA activities in the financial sector concerns the Financial Sector Assessment Program (FSAP). The FSAP is conducted jointly by the Fund and the World Bank. It was launched in 1999, partly in response to the Asian crisis and to the call by the international community for intensified cooperative efforts to monitor the financial systems of member countries. Its purpose is to provide member countries with a comprehensive evaluation of their financial systems, to alert national authorities to likely vulnerabilities in their financial sectors, and to assist them in the design of measures that would reduce these vulnerabilities.

An FSAP focuses on the linkages between the operations of the financial sector and macroeconomic performance. In particular, it examines developments in the financial sector, risks and vulnerabilities using a range of financial soundness indicators and

macrofinancial stress tests, and also examines different aspects of the institutional framework for the financial sector.

Since the program's inception, approximately 120 countries, or two-thirds of the Fund's membership, have requested and received an FSAP. A particularly important feature of the FSAP exercise is its relationship to surveillance. Because an FSAP will examine the financial sector in more detail than is contemplated in an Article IV consultation, the information and findings in an FSAP for a member are often used to inform the Fund's surveillance work with respect to that member.

International Codes and Standards

An important related initiative concerns the work of the Fund and World Bank to encourage compliance with international standards and codes in the financial sector. As part of a broader initiative, the Fund and Bank have adopted several standards and codes that specify good practices that countries should observe in designing and implementing their institutional frameworks governing different aspects of the financial sector.

While some of these standards were developed by the Fund, many others were developed by other international bodies with expertise in particular areas, including:

- Basel Committee's *Core Principles on Banking Supervision*;
- International Organization of Securities Commission's *Objectives for Securities Regulation*;
- International Association of Insurance Supervisors' *Insurance Supervisory Principles*;
- Committee on Payments and Settlements Systems' *Recommendations for Securities Settlement Systems*;
- Financial Action Task Force's *Recommendations* in the area of Anti-money Laundering and Combating the Financing of Terrorism.

Other standards address such issues as the conduct of monetary and financial policy, corporate governance, accounting, and auditing.

The Fund and Bank assess a member's compliance with these standards and issue a report known as a Report on the Observance of Standards and Codes (ROSC). The purpose of the ROSC exercise is to identify in a member's institutional framework areas that need to be strengthened. Many such areas may be addressed through subsequent technical assistance from the Fund.

As part of the standards initiative, the Fund has developed standards for reporting economic data to the markets—the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS). These focus on the practices that member countries employ in reporting economic statistics to the market. They recognize that the stability of a country's financial markets is likely to be strengthened by making accurate and timely economic data available to investors and market participants. If investors are fully informed of developments, they are less likely to overreact when market conditions deteriorate.

Transparency

The Fund's concern for transparency in economic reporting extends beyond the standards and codes initiative and beyond its TA activities. Beyond TA, a particularly important development in this regard is the Fund's Transparency Policy.

The policy is a relatively recent initiative under which the Fund seeks to publish its own reports on members' economies and economic policies. It is a departure from the Fund's traditional approach to the publication of such information, which was one of confidentiality. Historically, the Fund did not publish its reports on member economies or its views on their policies. The philosophy behind this approach was that it would be easier for the Fund to provide frank policy advice to a member and a member to accept that advice if the discussions were to take place behind closed doors.

This philosophy began to change in the midst of the emerging market crises of the mid- and late 1990s. The Fund began to recognize that the absence of timely and accurate economic information may actually undermine the stability of a country's economy. It therefore began to encourage members to consent to the publication of particular Fund staff reports on their economies and to the summaries of Executive Board discussions of these reports.

Still, there are rather strict limits within the Fund's legal framework that define the circumstances under which the Fund can publish any of these documents without a member's consent. Many such documents contain confidential information that members have provided to the Fund, and their consent is, of course, necessary before such information can be made public. Moreover, the Articles establish very stringent conditions under which the Fund can publish its views on a member's policies without that member's consent.

Notwithstanding these limitations, an enormous amount of material produced by the Fund on members' economies is now being published. The reason is that members have recognized the benefits of transparency and have generally consented to publication. This development has dramatically improved the quality of information available to the markets.

Fund Financial Assistance

The two tools discussed above—surveillance and technical assistance—are effective instruments that the Fund can use to prevent financial crises from occurring in its member countries. But what can it do if a crisis does occur? Imagine a country that has suffered a major financial meltdown that has mushroomed into a full-blown balance of payments crisis. In these circumstances the Fund will seek to stabilize the member's external position but, as part of this process, will also help restore its financial system to health. Some of the instruments already mentioned, such as technical assistance, may prove useful. But the principal mechanism that will be used is the Fund's financial assistance.

Under the Articles, the Fund may provide financial assistance to members to help them address a balance of payments problem. But

the Fund will only extend financial assistance if the member is prepared to implement a program of economic reform that is designed to resolve that problem. The financial assistance will be phased over the life of the member's program, and the conditionality attached to each disbursement will effectively require the member to implement particular features of its program, either by meeting specified economic targets or by implementing key structural measures, if it is to continue receiving disbursements.

In a country where problems in the financial sector were an important reason for the member's balance of payments crisis, the member's program will often focus on restoring the financial system to health. The implementation of measures designed to help strengthen the member's financial system may become explicit conditions attached to particular disbursements to the member. For example, such conditions may include the enactment of legislation designed to strengthen the legal and institutional framework for dealing with insolvent banks. Other important measures may focus on strengthening the corporate insolvency framework to facilitate the resolution of claims that domestic and foreign creditors may hold against insolvent corporate borrowers.

Financial stability in a member country is also restored by the resolution of claims held against the member country at the international level. These include claims held by foreign creditors on debt of the member government that is either overdue or that the member is unlikely to be able to service when it falls due. For a Fund-supported program to be viable, it is often necessary for various classes of creditors to agree to reschedule these claims in a manner that is consistent with the member's ability to pay.

The Fund and the creditor community have historically cooperated in seeking the orderly resolution of these claims. In recent years, this cooperative relationship has begun to experience difficulties, in particular as a result of changes in the ways in which governments in emerging-market countries have borrowed. While historically they have raised money in the form of syndicated loans from a limited group of large international banks, more recently they have relied upon public bond issues purchased by a myriad of different investors. Reliance upon public bond issues has

dramatically complicated the restructuring of such debt if the government is unable to pay. Stated simply, it is difficult to get a large and diverse group of bondholders to agree to a restructuring.

To address these problems of collective action, the official sector, including the Fund, has been promoting the development of a legal framework that would enable a qualified majority of creditors to make key restructuring decisions that would bind all creditors. In regard to the legal basis of such a mechanism, two alternative approaches have been proposed. One would be based on the contractual terms of the sovereign bonds. The other would be based on an international treaty, to be implemented through an amendment of the Fund's Articles of Agreement. The contractual approach, through the inclusion of collective action clauses in bond instruments, is clearly the preferred approach at this time. Because these issues are of central importance to Fund operations, the Legal Department will continue to closely monitor developments in this area.

Conclusion

The promotion of financial stability has become an important objective of the Fund. The Fund pursues this objective through all of its principal activities, including surveillance, technical assistance, and financial assistance. But an important feature of much of the Fund's approach is its emphasis on advice, persuasion, and ultimately cooperation. This approach stems from a recognition that the promotion of financial stability is a responsibility that is shared by the Fund, its members, financial institutions, and everyone within the international financial community.