Chapter 1

Market Discipline and Public Policy: The Role of the IMF

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1. Introduction and Theme

As such a distinguished gathering as this testifies, market discipline is an increasingly important topic for policymakers—in both the public and private sectors—around the world. The Federal Reserve Bank of Chicago and the Bank for International Settlements are to be congratulated for having the foresight to organize such an excellent conference.

I think it is fair to say that the past couple of decades have witnessed a major shift in the attitude of many policymakers around the world. They have become increasingly aware of the importance of markets, and market-friendly policies. They have also come to realize—many of them for the first time—the benefits that the discipline of the markets can bring—provided, of course, that they seek to use the markets for public policy purposes instead of trying to fight them.

This morning I want to look a little more closely at what those benefits are, and to examine how national authorities can best exploit those benefits in their response to markets. I want to argue that sensible market-oriented policies will help provide governments with a buttress against domestic and global instability. And I want to outline some of the ways in which the International Monetary Fund (IMF) is seeking to help in this process.

2. Looking Back

It is hard to believe now, but there was a time, not all that long ago, when many governments treated the markets—and above all, the financial markets, with suspicion. I am not referring here just to those countries that were part of the communist empire. Even what might have been thought of as relatively enlightened governments in the industrial world feared, or mistrusted market forces. Britain's prime minister, Harold Wilson, muttered darkly about the "gnomes of Zurich" in the wake of the devaluation crisis that nearly toppled his government in 1967. It was, of course, much easier to blame the power of the financial markets rather than his government's misguided economic policies.

In truth, governments relied for too long on policies that were essentially hostile to markets. It took time, and a great deal of effort on the part of many economists, for policymakers to learn quite how inefficient many of these measures were. In too many countries, governments could not resist the temptation constantly to extend their sphere of economic control—to micromismanage, if you like—even though neither their experience nor, indeed, their track record, gave any reason to expect them to be successful in generating economic wealth in the way that markets can do so well.

In one respect, public policymakers did display entrepreneurial flair: in devising ways for interfering with the markets. Credit rationing, for example, ensured that capital was allocated inefficiently—going all too often to favored economic actors, rather than those who could use it most effectively. Price controls meant that public sector utilities were—and in some countries still are—starved of much-needed investment funds. State-owned enterprises engaged in a wide variety of activities that, given proper price signals, would have been left to the private sector and been carried out in much more economic ways. In many cases, there was an absence of meaningful commercial codes for property rights: and in some countries, there still is.

But we are now seeing a revolution in the way governments, in both industrial and emerging economies, view the markets. The shift in attitudes has not been smooth. But shift there has been. And the progress in many emerging market economies has been particularly striking. Of course, policy reform in these countries is, inevitably, a more uneven process. They often start from a more extreme position, with very tight restrictions on markets. They have had to fight vested interests even more fiercely than industrial economies to make headway in freeing markets and adopting market-friendly policies.

But it is also striking to see some of the results that I believe can, at least in part, be ascribed to the greater willingness to recognize the potential gains to be had from enabling markets to operate more effectively. Twenty years ago, for instance, most developing and emerging market countries had double or even triple digit inflation. We sometimes forget how remarkable it is that nowadays, inflation in these countries is rarely into double-digit territory, and countries—such as Zimbabwe—with triple digit inflation are now extreme and rare cases.

And if we take the case of Chile, a country that has embraced markets earlier, more wholeheartedly, and more successfully than most emerging market economies, the results are unambiguous. This is a country that went from triple digit inflation to economic stability and prosperity in barely a single generation. Bad regulation—and by that I mean regulation intended expressly to prevent markets from operating effectively—was dismantled. A proper fiscal and monetary framework was put in place. Trade barriers were lowered. Accompanying that has been a series of reforms aimed at helping the markets function more effectively—such as those in the financial sector, for example, including the privatization of pensions.

The Chileans realized that it is not enough simply to embrace the market at the rhetorical level. Governments must construct a policy framework that enables markets to thrive. Yes, that means freeing markets from the sort of regulation that was intended to curb them. But it also means putting policies in place aimed at fostering macroeconomic stability—including budgetary discipline in the public sector. It means a readiness to let price signals work. It means, especially, establishing property rights and an effective judicial framework. It means efforts to combat bribery and corruption.

It also requires effective, well-designed measures that encourage competition and limit the scope for market-distorting behavior in the private sector. Markets can only flourish if policies are in place that provide appropriate incentives. Opening economies to international trade and world prices is one crucially important means of achieving this. In the Chilean case, high tariff and non-tariff barriers have been replaced with a uniform tariff of 6 percent.

Many other countries have successfully opened up their economies. Among emerging markets, trade barriers are a small fraction of their levels of 20 to 30 years ago, and even low-income countries have reduced them significantly.

3. The Role of the IMF

But markets do not function well in an environment of high inflation or high real interest rates. A major part of the Fund's role has been to work with our members to reduce fiscal deficits and improve the functioning of the financial system.

Improving fiscal controls is difficult, but essential. Better tax administration, more efficient tax structures (with fewer exemptions and broader bases at low rates) effective budgeting and expenditure controls are all essential. And this is a major part of the Fund's work. It is noteworthy that, even in Sub-Saharan Africa, those countries that have successfully implemented Fund programs, improving fiscal balance and public administration, have experienced a significant acceleration of their growth rates relative to other Sub-Saharan countries and their own past growth performance. And, as that has happened, the importance of a stable macroeconomic framework and good governance has been increasingly recognized as vital for good economic performance and growth.

Helping member governments develop and improve markets, to enable them to function effectively, is an increasingly important part of the Fund's work. In recent years, the Fund has been particularly concerned to help its members—all 184 of them—to develop sound economic policies aimed at promoting growth—policies that can help governments exploit the opportunities that markets can bring.

Most of the Fund's work in this area is not high profile. Significantly, though, it is work that is supported by many of those critical of other aspects of the Fund's activities. It is important. And we believe it is delivering results—though sometimes not as rapidly as we would like.

Helping governments to put the right arrangements in place is a coordinated effort, across countries and industries. The Fund works closely with the Bank for International Settlements (BIS)—and I know Malcolm Knight will be speaking at lunchtime—and the Financial Stability Forum. We cooperate closely with various international bodies, including the Basel Committee on Banking Supervision, International Organization of Securities Commissions (IOSCO) on securities regulation, International Association of Insurance Advisors (IAIS) on insurance supervision, International Accounting

Standards Board (IASB) on accounting, and International Fiscal Association (IFA) on auditing. These groups play a major role in setting standards in their areas of expertise. Thomas Jones gave an eloquent account of the work of the IASB last night. I think he brought home how great are the challenges that these international bodies face—at the intellectual and political levels.

The IMF tries to draw all these strands of work together. The most obvious way we can do this is in the surveillance work we do with every member state. As you know, every member has what we call Article 4 consultations with the Fund, whether or not a Fund program is currently in place. These consultations continue to be an important way of monitoring policy and providing timely advice. Such advice is, from time to time, unwelcome—fortunately, the Fund has never sought to win a popularity contest!

Our Article 4 surveillance work has, if anything, become even more important in recent years. That is partly because we have added to our armory. Most of you will probably be familiar with the Financial Sector Assessment Program (FSAP) introduced in 1999, a joint effort by the Fund and the World Bank, at least insofar as it involves low-income countries. Resilient, well-regulated financial systems are essential for macroeconomic and financial stability in a world of increased capital flows. The FSAP was designed to support member countries' own efforts to strengthen their financial systems. It aims to facilitate early detection of financial sector vulnerabilities, identification of key developmental needs, and to prioritize policy responses and provide technical assistance when needed to strengthen supervisory and reporting frameworks. The work under the program is supported by experts from a range of national agencies and standard-setting bodies.

The FSAP also forms the basis of Financial System Stability Assessments (FSSAs), in which IMF staff address issues of relevance to IMF surveillance, including risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks. Nearly sixty such assessments have now been prepared.

Alongside this work, we have worked closely with our members—again in conjunction with the World Bank—to help them put in place relevant standards and codes, which give rise to Reports on the Observance of Standards and Codes (ROSC). The reports summarize the extent to which countries have made progress towards observing certain internationally recognized standards and codes. There are 12 areas in which we support development and adherence to codes. These comprise data dissemination, fiscal transparency, monetary and financial policy transparency, banking supervision, securities regulation, insurance supervision, payments systems, anti-money laundering and countering the financing of terrorism, corporate governance, accounting, auditing, and insolvency and creditor rights. The financial sector ROSCs are an integral part of the Financial Sector Assessment program. The ROSCs are prepared and published at the request of the member country. They are used to help sharpen policy discussions of both the Fund and the Bank with national authorities, and in the private sector (including by rating agencies) for risk assessment.

We have also stepped up our efforts to provide technical assistance. Again, this is hardly the sort of work that makes the front pages. But I believe it is a vital part of our work. In the past the importance of having the right institutional and judicial frameworks in place was often overlooked. Nowadays, we recognize that such arrangements are critical ingredients in developing market-friendly and sustainable policies. We can provide assistance—and encouragement—to countries who need to revise their judicial frameworks, reform institutions, develop bankruptcy laws, strengthen property rights, construct equitable and efficient tax regimes, and reduce corruption. Many countries need help in establishing, for instance, proper systems for monitoring and reporting public expenditure, the collection of reliable statistics, and payments systems. The Fund provides expertise and training in these areas.

4. Transparency

One of the most important changes in the way we work as an institution, and the way we are encouraging our member countries to work, is our attitude to transparency. One of the charges that Fund critics most frequently articulated was that we were a secretive institution, busily deciding the fate of national economies behind closed doors. This criticism hit home—not least because it was true! The Fund had no tradition of public engagement. The institution hated being in the public eye. And, to be fair, most member governments quite liked it that way. It meant they could fudge matters when they received unpalatable advice.

The critics still complain of the IMF's secretive ways—conspiracy theorists, after all, love to attack faceless and nameless bureaucrats. But now, I'm pleased to say, those critics are wrong. The Fund might give the impression sometimes of being slow to change. But on the issue of transparency, the institution has undergone a dramatic—and swift—revolution. It's a revolution that many of the critics are finally beginning to notice.

We are now one of the most transparent organizations in the world. Our website is packed with information that until recently the Fund would never have dreamed of publishing. Information junkies could overdose on the amount of detailed material we now regularly release.

There were two motives behind this drive for transparency. One was an attempt to deflect criticism—only partially successful, as I have said, because, as we have now learned, critics are not always influenced by facts.

The second and more important motive was an attempt to lead by example. Transparency—of policy objectives, of decision-making, and the decision-making process—is more than just a fad. It is clearly one of the most effective ways to engage markets and gain their confidence. Markets loathe uncertainty. The markets can price in bad news, and even unwelcome policies: What they do not know, though, they cannot price.

So transparency works in two ways. First, it provides markets with clear evidence of policy intentions and actions. Second, it reinforces the drive to make those policies sound, since governments are under greater pressure to deliver sustainable policies.

This is a battle I can confidently say we are winning. We have persuaded most member governments that transparency is a desirable objective. Indeed, with the support of our members, we have recently introduced a modification to our procedures as they relate to publication of Article 4 consultations. The standard presumption is now in favor of publication of such reports. The fewer the number of countries that prefer to withhold information, the more suspicious will be the markets of those countries that do so.

We should not underestimate quite how far we have come in this regard. We see an increasing number of emerging market economies in particular working to engage more openly with the financial markets. Governments are beginning to recognize the benefits of explaining to market practitioners what they are doing, and what they hope to achieve. In some cases, formal consultative procedures have been established. All this helps to build confidence in both directions. Markets trust open governments more than secretive ones; and open governments find it easier to understand how markets work and to explain their policies. The better and more detailed the explanation, the fewer surprises that governments are then likely to spring on unsuspecting markets.

And transparency brings results. Carrots are always better than sticks in the battle to convert reluctant skeptics. A recent IMF working paper showed that improving transparency does lower borrowing costs, as measured by sovereign spreads. The research also found that markets respond not just to the *publication* of reports such as Article 4 consultations, or Reports on the Observance of Standards and Codes, but to the *content* of those reports. This, of course, is entirely consistent with the argument that transparency reinforces the pressure for the development of sound economic policies.

I cannot resist noting that both inside and outside the Fund, some of the most vehement critics of transparency are now some of its most enthusiastic advocates. Nothing succeeds like success!

5. Crisis Prevention

All the work I have described comes under the very broad heading of crisis prevention. It reflects the Fund's core aim—unchanged since we were established nearly sixty years ago—of helping to provide a stable international financial system that in turn can help promote growth and international trade. Stand-by agreements, for example, are intended to provide a cushion for governments affected by market turbulence, but whose fundamental policies appear sound.

Take the recent case of Brazil. In mid-2002, the country was gearing up for its presidential election in November. Brazil had a large debt burden, but it appeared to be sustainable. Its macroeconomic policies were sound. But investors apparently doubted that these policies would be sustained by the successor government. The IMF support announced at that time of investor uncertainty during the pre-election period came about only after all the presidential candidates have indicated that they would abide by the accompanying program. This committed the incoming government to maintenance of the fiscal and monetary framework and thus reassured the financial markets. The new government's commitment to sound and sustainable policies has been maintained and markets have to date remained calm. A year ago, the spread on Brazilian bonds was about 2,400 basis points—it is now about 650.

It can certainly be argued that the market pressures during the summer of 2002 helped persuade Brazilian politicians and the public alike of the importance of adhering to the macroeconomic framework—and Brazilians are beginning to feel the benefits.

6. Crisis Resolution

Of course, even if the Fund were always right in its Article 4 assessments, governments would not necessarily follow the advice on offer. There are many reasons why a government might want to delay acting on external advice or might choose to ignore it altogether. And unless a government seeks financial assistance from the Fund, the staff ultimately has little leverage in persuading reluctant governments to introduce reform. But failure to heed warnings by the Fund will certainly lead to crisis in some cases. Crises will also erupt because of unexpected economic shocks.

The Fund's role in crises resolution remains important; and it is, of course, still the most high-profile aspect of our work. Even at this stage, the IMF is still seeking to help governments adjust their policies in ways that make them more market-friendly, although it is also seeking to give governments some protection from the impact of market turbulence. As with Brazil, the markets themselves provide a signal to governments and the public of the importance of developing and adhering to a sound macroeconomic framework.

The IMF programs for countries seeking financial assistance are agreed jointly between them and the Fund. Nowadays such programs will always include a shift towards greater transparency, economic sustainability, and institutional reform. Markets base their assessment of a country's economic prospects on a wide range of factors: the right objectives must be in place, of course, but so must be convincing ways of delivering those policy aims. Implementation is often a problem.

Measures to restore economic stability and a commitment to longer-term economic reform are critical elements in the process of crisis resolution. Equally important in the immediate aftermath of a crisis, though, is a speedy and orderly resolution to the debt problem that in many cases precipitated trouble in the first place. Here we have, I think, made some progress recently. The wide-ranging public debate we initiated on the sovereign debt restructuring mechanism did much to focus people's minds on what constitutes the most effective response. Already, one tangible result of this debate has been the adoption of collective action clauses (CAC) by ten countries that have issued bonds under New York law this year. Both governments and market practitioners had previously been reluctant to extend the use of CACs beyond the jurisdictions—such as English law—where they have long been standard.

Resistance to CACs reflected fears that the markets would demand a penalty for bond issues where they were included. It soon became apparent, though, that such bond issues attract no such penalty. There have been some sovereign bond issues that did not include CACs this year, but most such bonds issued in New York now include them as standard. Indeed, interest has now shifted towards refinement of these clauses.

Work is now under way—and much of it is in the private sector—to build on this success by examining the opportunities for aggregation across different types and maturities of debt. The most recent bond issues by Uruguay represent a first step in that direction. The challenge, though, is to find a formula that best balances the benefits to be had against the risks that this could be vulnerable to abuse. Most concern centers on two issues: the scope for inter-creditor discrimination and the possibility of manipulation by the sovereign debtor.

7. Conclusion

In terms of recognizing what benefits markets can bring, I think we have come a long way in recent years. In most cases, I think we have won the philosophical battle. Governments around the world are now, by and large, ready to acknowledge the role that markets do and should play in the domestic and international economies. Globalization has brought home to those whose instinct is perhaps to remain suspicious that governments and markets have, at the least, to establish an effective and productive way of working together.

Of course, governments will always be tempted—to take the easy path, to resist or ignore unwelcome market pressure, to postpone difficult and unpopular reforms. Markets can have an important role in helping governments stick to the right path—and in so doing help those governments deliver the stability and prosperity that their citizens want.

The IMF also has a role in keeping governments on the straight and narrow. By encouraging governments to see what benefits the markets can bring, and to help them exploit those benefits to the full, the Fund is working with the markets, not against them. It truly is a collaborative process.

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