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Can standards and codes prevent financial crises?

Benu Schneider and Simon Maxwell

Gordon Brown has long argued that one of the main ways to manage the world economy better and avoid financial crises is to define and implement international "standards and codes". These are statements of best practice in areas like fiscal transparency, banking supervision and accounting standards. They provide reassurance to members of the international financial 'club' that everyone is playing by broadly the same rules, or at least not exposing the club as a whole to unreasonable risk. In 1999, Gordon Brown described standards and codes as 'the foundation of the new architecture'. 'It is only', he said, 'by taking the right actions in their own jurisdictions that the countries of the international financial community can deliver financial stability at global level. It is only in this way that we can achieve global stability consistent with national sovereignty.'

Four years on, the world is blessed with as many as 77 agreed standards, of which 12 are considered 'key' (see Figure) – and also with a surveillance apparatus to assess compliance. The key instrument is the ROSC, the Report on the Observance of Standards and Codes, prepared by the IMF as a part of Article IV consultations, or through joint missions with the World Bank on Financial Sector Assessment Programmes (FSAP). There are currently ROSCs for 79 countries. There is also some self-assessment in the public domain, and some private sector activity.

Core Financial Standards

Macroeconomic policy and data transparency

- Code of Good Practices on Transparency in Monetary and Financial Policies
- Code of Good Practices in Fiscal transparency
- Special Data Dissemination Standard and General Data Dissemination System

Institutional and market infrastructure

- Principles and Guidelines on Effective Insolvency Systems
- Principles of Corporate Governance
- International Accounting Standards
- International Standards on Auditing
- Core Principles for Systemically Important Payment Systems
- The Forty Recommendations of the Financial Action Task Force on Money Laundering and eight special recommendations on terrorist financing in the aftermath of 11 September 2001

Financial regulation and supervision

- Core Principles for Effective Banking Supervision
- Objectives and Principles if Securities Regulation
- Insurance Supervisory Principles

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Standards. Transparency. Monitoring. Who could object? Well, no-one, of course, except that from the point of view of developing countries, and as a new book shows,* the standards and codes initiative raises some difficult issues.

First, the standards and codes have not emerged as the result of a participatory process, jointly owned by all countries. Rather, these are standards usually devised by richer countries, mainly the G7, acting through the Financial Stability Forum, with only a few developing countries present as observers. The implication is that what works for the G7 will work for everyone – an assumption which even relatively well-regulated countries like India have questioned.

* Benu Schneider (ed) The Road to International Financial Stability: Are Key Financial Standards the Answer?. Palgrave, Macmillan in association with ODI. 2003

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Second, the unspoken implication is that OECD countries will easily conform and that these measures are aimed at back-sliding club members in the developing world. In fact, compliance is far from universal even in the G7, and monitoring is also patchy. For example, there was no ROSC for the US or Germany until August this year, and coverage even now extends only to fiscal transparency. Recent history shows that ENRON-style scandals and shocks originate as often in developed as in emerging economies.

Third, the assumption is that countries which fall below the standard can easily improve. But, the implementation of codes in corporate governance or banking supervision is complex and expensive, and requires large numbers of trained staff that developing countries do not immediately possess. Imposing too high a standard initially can be a barrier to participation in the world economy.

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Fourth, there are questions about who decides on whether standards are being met, and what is done with the information. The Bretton Woods institutions face a particular conflict of interest, responsible for monitoring compliance and providing information to markets, but also for providing credit to countries. Developing countries see the enthusiasm for ROSCs as one more tool in the armoury of the IMF, and very much fear that they will become part of Bretton Woods conditionality.

Fifth, there is an important debate over whether the large costs of implementation are justified by the supposed benefits. There is no conclusive evidence that favourable ROSCs lead to lower spreads on international bond issues (although studies have found minor impact on credit ratings). Furthermore, the uneven coverage across codes and countries means that the assessments are of limited usefulness: Argentina, for example, received a favourable IMF assessment of its banking supervision only a year before its financial-sector meltdown in 2000.

Finally, and ironically, implementing standards can even undermine financial stability. Avinash Persaud has argued that although transparency is a good thing, too much transparency may encourage herding behaviour by traders and make volatility worse, not better. For example, the publication of daily data on reserves can simply signal to investors that others are leaving the market – and they had better do so too. Recent attempts to distil ROSCs into quantitative 'tick-box' assessments, stripped of individual context, have made this risk worse.

Does all this mean that standards and codes are the wrong way to go? No. Rather, we conclude that three changes are needed.

First, oversight of the process needs to be opened up. In particular, developing countries need a greater voice at the Financial Stability Forum and at the Bank for International Settlements. An immediate consequence would be recognition that improving performance is a long-term project, requiring investment and technical support: a process taking years, not an easily implementable initiative in the short-run.

Second, there are better ways to manage monitoring. Self-assessment by countries, backed up by a peer review process, offers the potential for independence, ownership and rigour. This is already the approach of choice in many areas for the OECD. It would minimise both the extraordinary cost and difficulty of managing a centralised monitoring system, as at present, and would also reduce the potential for conflict of interest by the IMF and the World Bank.

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Third, and most important, G7 finance ministers need to recognise that standards and codes on their own are unlikely to provide protection against capital surges and financial crises. They are necessary but not sufficient. The crucial need is for a mechanism for provision of liquidity when the first signs of problems emerge, so that a disaster can be averted. The IMF's Contingent Credit Lines, which lapse in November, went unused because of the conditions attached. Other important areas for policy intervention are debt resolution and even defining the threshold levels of debt for middle incomes.

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Benu Schneider was a Research Fellow at the Overseas Development Institute and is now with the Globalisation and Development Strategies Division of UNCTAD. She writes in her personal capacity. Simon Maxwell is Director of ODI.

Overseas Development Institute, 111 Westminster Bridge Road, London SE1 7JD
Tel: +44 (0)20 7922 0300, Fax: +44 (0)20 7922 0399
Email: opinions@odi.org.uk
Website: www.odi.org.uk/opinions