

# Part V

## Epilogue

# The Challenges for the International Financial System at the Eve of the 21st Century

*Age Bakker*

The discussions on the promotion of international financial stability in this Fondad-sponsored conference have been wide-ranging and stimulating. The turmoil in financial markets has exposed weaknesses in the functioning of the international financial system, as well as in the policy responses to resolve the crisis. Among the participants there was a wide area of agreement on some of the elements of reform, which are needed in order to strengthen the robustness of the system. But the discussions have also pointed out a research agenda on policy issues where further analytical work is needed.

## I Essential Fundamentals

To begin with, there is general agreement on the main ingredients of sound macroeconomic policies in industrial and emerging economies alike. A stable macroeconomic environment with solid government finances, prudent monetary policies and market-oriented structural policies are a precondition for sustainable economic growth and a robust financial sector. The financial crisis has shown, however, that there is not a clear understanding among policymakers and academics of the pros and cons of some elements of what would constitute a sound macroeconomic strategy. First, there is the question of the appropriate exchange rate regime for emerging economies at different levels of development in a liberalised environment. It seems to me that further research is needed on the relative merits of fixed exchange rates, flexible exchange rates, and intermediate systems such as a crawling peg. In doing so, the policy implications of the choice for a particular regime need to be clarified. A second area of research, closely related to the former, might be the deployment of monetary policy instruments once there is a speculative attack on the currency. Some argue that the central bank should increase interest rates swiftly as soon as there is a speculative attack in order to restore confidence. Others have warned about the potential negative effects for the real economy and the financial sector. So we need to look further into these two issues.

Recent events have also shown that sound macroeconomic policies are not enough. At this conference, there has been a search for other fundamentals that count. In particular, we need to look more at the institutional settings that are complementary to sound macroeconomic policies and can thus enhance the robustness of an economy. One of these is the regulatory framework for capital movements. Few would contest the desirability of the ultimate goal of liberalised capital movements. The opening up of financial systems has enabled emerging economies to attract huge amounts of capital for rapid development. Free capital movement can promote growth, prosperity and stability, when properly embedded in sound macroeconomic and structural policies. However, experience in both industrial and emerging economies has shown, that if the liberalisation of capital movements is not accompanied by proper measures in other areas, this may lead to financial crisis. An orderly and proper sequencing of liberalisation and deregulation of financial markets is called for. The speed of opening up particular types of the capital account must depend on how fast and how effectively the reforms in other policy areas are carried through. Progress depends, *inter alia*, on the advances in: (i) privatising financial institutions; (ii) enhancing risk management capabilities in the banking sector; (iii) improving supervisory capacities; and (iv) enacting the appropriate regulations and enforcing them. The financial infrastructure of a country must be capable of handling international capital flows. Equally important, but often overlooked, is that the corporate sector must know how to function in these liberated financial markets. Economic actors have to adjust to the market environment – transparent corporate governance and internal risk management of companies are crucial issues here.

## II Volatility of Short-Term Flows

More research is needed with respect to the appropriateness of measures to reduce excessive volatility of short-term capital flows. There may be a case for emerging economies to resort to measures aimed at avoiding excessive short-term inflows. The Chilean experience often is referred to as an interesting example of disciplining the domestic financial and corporate sector by discouraging short-term foreign currency debt accumulation. More work needs to be done as well on the appropriate response to excessive and destabilising short-term outflows. Restrictions on short-term capital flows may provide temporary relief, but they cannot be a long-term substitute for sound macroeconomic and regulatory policies.

In those extreme cases, where temporary restrictions can help to create breathing space for implementing the necessary adjustments, it may be

well advised to do so in the context of an IMF-supported adjustment programme in order not to damage investor confidence. In general, the IMF can play a useful role in helping countries with a properly sequenced liberalisation of capital movements. In this respect, as part of the reform of the international financial system, efforts to empower the IMF for guiding the liberalisation process by amending the Articles of Agreement deserve support.

The volatility of international short-term capital flows have exposed major weaknesses in proper risk assessment procedures by financial market participants, both in debtor and creditor countries. The functioning of financial markets, and especially the mechanisms of international credit expansion, should be part of the research agenda. From understanding how financial markets work one might go to how one could modify their behaviour. It may be worthwhile to remember the circumstances in the late sixties when attempts were made to monitor the development of international liquidity in the context of macroeconomic supervision. The question raised at the time was whether not too much international liquidity was created through the Eurodollar markets. To this there was no easy answer and policy-makers and academics got lost in methodological issues. But I think the question is coming back to us and we should try to develop new ways to examine the market mechanisms of international short-term flows.

### **III Preventing Contagion and Bailouts**

The international response to the financial turmoil thus far has not succeeded in avoiding huge adjustment costs for the affected countries. Nor have efforts to restore confidence, especially in some countries which experienced the onset of the financial crisis more recently, been very successful thus far. In some of these countries this was partly due to domestic political instability, which may have exacerbated the crisis. The mixed effectiveness of the international community's response to the crises makes clear that both the adjustment policies of the countries concerned and the crisis management strategy of the international community need to be evaluated carefully. The current strategy, whereby increasingly large rescue packages are made available to countries in a financial crisis, cannot be sustained much longer. The IMF's liquidity has decreased sharply, problems of moral hazard have increased, and the packages have been only partially successful in combatting the crisis.

Two basic questions with respect to crisis management are still out there where agreement is lacking. First, some have argued that the IMF should dispose of more unconditional liquidity for countries under speculative

attack. Also, proposals for pre-emptive or contingency financing packages for countries in good shape but which risk to be affected by contagion have been advanced. Others, on the contrary, have argued that the IMF packages are getting too large and that the IMF should go back to its original catalyst role. This leads to a second area for research, namely the involvement of the private sector. The handling of the Asian crisis has shown that it is crucial to involve the private financial sector in rescue operations at an earlier stage. Better procedures to deal with a crisis once it has emerged will have to be developed, which should aim at an appropriate burden sharing between the official and private sector in order to avoid moral hazard. Establishing an effective communication network between public and private sectors should be considered. The Institute of International Finance could play a role here. Yet, the way in which the private sector can be involved will continue to depend on the structure of the external debts of the country involved, and will therefore have to be determined on a case-by-case basis.

The analytics and the transmission mechanisms of contagion constitute another important topic for the research agenda. Further work is needed with respect to the factors causing contagion, such as competitive devaluation; the reassessment of credit risk and liquidity risk in volatile market conditions; portfolio benchmarks for regions or categories of countries; and proxy hedging if markets become illiquid. If we know more about chains of causation, countries might be able to prevent contagion from happening.

#### **IV Strengthening the Architecture**

There is general agreement on the need to strengthen the robustness of the financial sector. Establishing an efficient and resilient domestic financial infrastructure is an important precondition for reaping the benefits of financial globalisation. The Basle supervisory committee in collaboration with supervisors in emerging economies has defined the core principles for sound and effective banking supervision. What is needed now is that these principles are actually implemented. The international financial institutions have agreed to use these standards as a benchmark for evaluating supervisory regimes in the context of their regular consultations with national authorities. But more work needs to be done. In particular, there is a need for improved risk management among major financial market players. The Basle capital adequacy rules, useful as they have been in creating minimum standards for strengthening bank capital around the world, have become too imprecise and cannot sufficiently differentiate between

various risks. An update of that accord has become rather urgent.

Supervisory action needs to be complemented by the discipline of market forces. Proper risk assessment can be enhanced by improving financial transparency. Information should be reliable, timely and disclosed in an accessible manner by official and private market participants alike.

In sum, there is a considerable agenda for research and for policy action. The international financial institutions and national authorities should coordinate their efforts to reduce systemic risk by strengthening financial sector surveillance. There is no need – or should one rather say no time? – for a complete overhaul of the existing international financial architecture. The building blocks for a cooperative framework are there already. But an urgent strengthening of the architecture is needed.