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Keynote Speech

Strengthening the International Financial Architecture, 2004

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Efforts to strengthen the international financial architecture have been ongoing now for ten years. I date those efforts to the Mexican financial crisis of 1994, which Michel Camdessus referred to as "the first financial crisis of the 21st century" on the grounds that financial structure had played an unprecedentedly prominent role in its development.[2] The tenth anniversary of these efforts is a logical time for stock taking.

Of course, other observers would place the inauguration of this effort even earlier, perhaps at the time of the 1982 Mexican crisis out of which developed the Brady Plan, or the 1974 Herstatt crisis that provided the impetus for the Basel Capital Accord, or even the global financial crisis of the 1930s that prompted the creation of the Bretton Woods institutions. But there is a second justification for stepping back now and taking stock. As we meet here in Santiago, all the ingredients are in place for a classic emerging market crisis.[3] We are coming to the end of a long period when the Federal Reserve has kept interest rates low.[4] Partly in response, spreads on emerging market debt have fallen to very low levels. U.S. policy rates are about to rise, and rising U.S. rates are a traditional trigger for financial problems in emerging markets. Market participants see this coming: we have already experienced a bond market shock not unlike that of 1994.

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[1] Plenary address to 3rd Annual PECC Finance Conference, Sheraton Santiago Hotel & Conference Center, Santiago, Chile 21 June.
[2] See Camdessus (1995).
[3] The parallels with previous crisis periods are unmistakable; see Eichengreen and Fislow (1998).
[4] In the early 1990s the reason was to cope with the Savings & Loan crisis in the United States. This time around, the rationale was fear of deflation.

Meanwhile, oil prices are also rising, creating additional difficulties for emerging markets that are not energy exporters.[5] And global economic growth is entirely dependent on two engines: the United States and China. There are fears of a hard landing in China as policy makers attempt to cool down an overheated economy and of a dollar crash in the United States if the problem of twin deficits finally comes home to roost. The U.S. is the single most important market for exports of consumer goods by emerging markets, while China is far and away the most rapidly growing market for both consumer and producer goods. If either engine begins to sputter, the result could be very serious problems for emerging markets that are heavily dependent on exports for both growth and debt sustainability.

Thus, it is somewhat surprising that this potentially fatal cocktail of rising U.S. interest rates, higher oil prices, and slower Chinese growth has not yet produced serious difficulties. Worries there are, to be sure. There is growing concern about debt sustainability Turkey and Brazil. There is much discussion of how a slowdown in China will affect that country's East Asian neighbors. But there is no crisis.

One response to this observation is "just be patient." Give it more time, and the financial ambulance chasers among us will eventually acquire a new set of clients. But another response is that considerable progress has in fact been made in strengthening the international financial architecture. Reforms of international financial institutions and markets have strengthened the global financial system, while significant reforms in emerging market economies themselves have made these countries more resilient to mounting strains.

[5] The OECD estimates that China and India are two to three times more intensive in the use of energy than the typical developed countries and that an increase of $10 in the cost of a barrel of oil shaves 0.8 per cent off of China's rate of GDP growth and 1 per cent off of India's.

There is at least a kernel of truth in this point of view. Specifically, I would point to ten important reforms that have helped to make the world a safer financial place. However, these reforms have come at a cost. Each of them has had unintended consequences that are not entirely salutary from the point of view of either emerging markets or the international system.

First, emerging markets have grown more cautious since 1994, and especially since 1997, about cross-border bank borrowing as a way of accessing external finance. Less reliance on short-term finance, and less reliance on cross-border bank finance in particular, has reduced an important source of financial vulnerability. The banks, for their part, have grown more cautious about cross-border lending, having been reminded of the risks of international financial intermediation by earlier crises.[6] New net flows through money markets and new bond flotations have also fallen, albeit by less than cross-border bank lending and less in Asia than Latin America.[7] Be that as it may, the point is that emerging markets have taken valuable steps to lengthen the maturity structure of their debts.[8]

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[6] To be sure, international banks are even more active in emerging markets than was the case ten years ago. But they now fund most of their lending activities in those markets out of local deposits. However much their presence enhances the efficiency of international financial intermediation, this does not make foreign banks a source of external finance.

[7] After peaking at $150 billion in 1995, net private debt flows to developing countries fell steadily for three years, approaching zero in 1999. Net bond-related flows fell by half, from $49 billion in 1996 to $19 billion in 2001, while bank loans fell even more dramatically, from $51 billion in 1998 to negative levels the following year. In 2000 net debt flows to developing countries were negative; in 2001 and 2002 they were barely positive. If one limits one=s attention to the subgroup of developing countries classified by the Institute of International Finance as emerging markets B supposedly the leading destinations for capital flows B the picture is essentially the same.

[8] Turkey and Brazil are prime cases in point. The maturity of the debt has lengthened from an average of 7.7 months in January 2001 to 15.3 months in June 2004. Fixed rate debt has been raised from 25 per cent of total domestic debt in 2002 to 38 per cent today. And foreign-currency indexed or denominated debt has declined from 32 per cent of domestic debt in 2002 to 19 per cent today. In Brazil, the average maturity of the domestic debt has risen to some 20 months from little more than 5 at the time of the 1998-9 crisis.

Second, emerging markets have become more prudent about running current account deficits.[9] Latin America as a whole is running a balanced current account. Of the principal Latin countries, only Ecuador has a noticeable deficit. There are no 21st century equivalents of Thailand, which was running a current account deficit of 7 per cent of GDP in 1996.[10] Only recently has China, which has been on the receiving end of a remarkable surge of inward foreign investment, begun running modest deficits. Thus, the notorious problem of current account reversals – what happens when funding for the flow deficit suddenly dries up – has been very considerably ameliorated.

The problem with these solutions to the problem of financial instability, if we may call them that, is that they imply foregoing many of the benefits of capital mobility. International capital mobility should have allowed a country like Chile, which experienced a negative commodity-market shock in 1998, to smooth its consumption by tapping international capital markets. In practice this did not occur. Moreover, in a period of unprecedentedly low U.S. interest rates, we would have expected Latin American countries hungry for growth to fund additional investment by accessing international finance. Again, this did not occur. The growth of foreign direct investment is one thing, but portfolio capital continues to flow upstream from the developing to the developed world. Thus, this "solution" to the problem of financial volatility comes at a significant cost.

A third stabilizing development is the massive accumulation of foreign reserves by emerging markets.[11] Reserves provide insurance against financial shocks. Even if

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[9] Thus, the view that large external deficits are benign when they reflect strong investment demand rather than weak saving (the so-called Lawson Doctrine) has been discredited.
[10] The most worrisome current account position is probably that of Turkey, at 3.4 per cent of GDP.
[11] Most obviously in Asia but in Latin America as well.

external debt cannot be rolled over, reserves are still available to service it. But they provide insurance at a cost, in the short run because the yield on U.S. treasury bonds is less than the opportunity cost of funds, and in the long run because the twin-deficits problem in the United States implies capital losses on dollar-denominated assets. Reserve accumulation is therefore a sign that net capital transfer from rich to poor countries is effectively even less than meets the eye.

Fourth, there is the fact of greater exchange rate flexibility. I regard this as one of the most significant reforms of the international financial architecture. Greater flexibility has reduced the temptation for governments to stick with unsustainable policies. It gives them additional capacity to use macroeconomic policy in stabilizing ways. It creates two-way bets for speculators, removing a focal point for destabilizing financial dynamics.

Except for Ecuador and Venezuela, all of the principal Latin American countries have now adopted flexible exchange rates. But while the Mexican peso now floats freely and the Brazilian real has been allowed to fall by about 9 per cent since financial market participants began contemplating rising U.S. interest rates, other emerging markets remain reluctant to let their currencies move. Asian countries fear the implications for export growth. Latin American countries fear the financial consequences, given the extent of exchange-rate linked debt. Fear of floating is still a problem, in other words.[12]

Fifth, stronger fiscal policies in emerging markets have reduced the risk of old-fashioned ("first generation") crises. In Latin America, improvements in fiscal discipline were long overdue, and in the short term their implications for financial stability were strongly positive. The problem is the inability of governments to pursue their social agendas, which raises questions about the durability of political support and therefore

[12] See Calvo and Reinhart (2000). I will return to this problem.

about the sustainability of the policies. Running primary surpluses to pay down the debt also leaves a smaller share of tax revenues for investment in infrastructure and education, with negative implications for growth. The commitment to primary surpluses also means that fiscal policy is dangerously procyclical, since the worse the country's economic performance, the larger its surplus must become.

Sixth, leverage in the international financial system has been reduced, moderating one important threat to systemic stability. Following the LTCM crisis in 1998, banks curtailed the amount of credit that they made available to hedge funds.[13] The "macro funds" that were the most voracious consumers of leverage have since gone out of business or changed their investment styles. This raises hopes that if an unexpectedly rapid rise in U.S. policy rates unleashes a flight to quality and causes sudden deleveraging, the impact on the international system will be lessened. The problem is that recent data suggest that the use of leverage is growing again – at least so far as we can tell, given that information on the still largely unregulated hedge fund industry is thin on the ground.

Seventh, multilateral surveillance of financial systems has been strengthened. I can remember visiting the IMF's Capital Markets Division in 1995 when it occupied a small bank of offices in one of the Fund's satellite buildings. Now the Capital Markets Department occupies the better part of a floor in the Fund's headquarters. The IMF issues a *Global Financial Stability Report* twice a year. There are regular reviews of prudential supervision and regulation in the context of the Financial Sector Assessment Program. But there remains the problem that IMF expertise is still heavily dominated by the macroeconomic side. The IMF continues to hire new Ph.D.'s in economics, as

[13] See Eichengreen and Park (2002).

opposed to people with experience in bank supervison and securities market regulation. And the Capital Markets Department spends too much time writing the equivalent of low-level investment-bank newsletters for internal consumption while doing too little analytical work.

Eighth, there is the effort to promulgate standards and codes designed to enhance transparency and strengthen market discipline, backed up by the Bank and Fund's Reviews of the Observance of Standards and Codes (ROSCs). While it is still early, there are some indications that the markets take these efforts seriously and reward countries that subscribe to the SDDS or adhere to the international financial community's other standards and codes with lower borrowing costs and improved credit ratings.[14] The problem is that the benefits may turn out to be less than meets the eye if public information crowds out private information. At least one study suggests that when countries subscribe to the SDDS or adopt internationally-recognized accounting standards, there is a decline in the number of private analysts following the country, since investing in private information generation and acquisition become less profitable. The increase in the accuracy of information produced by the improvement in public information is partly offset by the reduction in the accuracy of privately-generated information associated with the fall in analyst following.[15]

Ninth, there is the addition of collective action clauses (CACs) to debt securities governed by New York law. In the last 15 months this contractual innovation, which was long dismissed as infeasible, has become the norm.[16] There is reason to hope that the

[14] See for example Cady (2004).
[15] See Tong (2004).
[16] In the latter part of 2003 and early part of 2004, sovereign issues containing CACs constituted more than 75 per cent of the total value of bonds issued in the period. See IMF (2004).

addition of majority consent provisions to sovereign debt instruments will ease holdout problems and facilitate orderly restructuring. The prospect of less painful restructurings gives grounds for expecting that the IMF will be able to stand aside and let events run their course when countries have unsustainable debts. There will be fewer cases like Argentina in August 2001, in other words. This will reduce the moral hazard associated by the expectation of bailouts, in turn strengthening market discipline.

But it will take until the end of the present decade, or longer, until CACs dominate the stock of emerging market debt securities. In addition, issue-specific majority voting rules do little to facilitate coordination among the holders of different bond issues, a problem whose importance is apparent in Argentina's default. So long as coordination remains difficult, restructuring will remain difficult. It is not yet certain, in other words, that collective action clauses will make a difference.

Tenth and finally, the IMF has become more transparent. Stan Fischer refers with some justification to the "revolution in IMF transparency" that occurred on his watch. The IMF now posts so much information on its website that it is difficult for its critics to keep up. Some would say that this is a clever ploy to disable the critics! More seriously, making policy in the light of day forces the Fund to justify and defend its decisions. It enhances the institution's ability to make credible commitments. In principle, it also makes it more difficult for the Fund's principal shareholders, like the United States, to use the institution as a vehicle for advancing its foreign policy goals, as opposed to addressing problems of financial instability.

But while the IMF has become more transparent, questions can still be asked about whether it has become more accountable.[17] The representativeness of its managing board can be questioned. The procedure used for selecting its managing director is hardly open, even handed, and merit based. These problems undermine the legitimacy of the institution and hence the credibility of its commitments. Clearly, while there has been progress in the direction of greater transparency and openness, there is still an accountability problem.

This brings me to the agenda for 2004. What key reforms remain incomplete? What are the most important tasks going forward? How can we continue to strengthen the international financial system while minimizing corollary damage to emerging markets? Every member of this audience will have his or her own answers to these questions. Let me conclude, then, by indicating my own view of which tasks should be priorities.

The first item on my list, while the least exciting, is at the same time the most important. It is more business as usual. I mean redoubling efforts to strengthen banking systems, enhance shareholder rights, improve the effectiveness of corporate governance, and heighten the transparency and efficiency of financial markets. This effort to improve the structure, regulation and efficiency of financial markets, first and foremost at the national level, has been the touchstone of recent efforts to strengthen the international financial architecture. There has been progress, but much remains to be done. While this observation is commonplace, it is no less important for that fact.

The second item is to create a credit culture in emerging markets. When cheap credit becomes available, it flows in large amounts into the property market and other

[17] Many of the same questions apply to the World Bank.

speculative investments, with too little attention to the decline in credit quality that occurs with the pursuit of higher risk projects. More investment means faster growth, at least temporarily, which attracts more foreign investors impressed by the improvement in economic performance. The result is self-reinforcing, procyclical, and dangerously unstable dynamics.

The solution to this problem is to more efficiently price credit risk. Doing so is the job of bond markets.[18] The implication is that emerging markets need better bond markets. Developing them will have a number of corollary benefits, including reducing dependence on bank finance and limiting currency and maturity mismatches. While I have doubts about the efficacy of some fashionable initiatives in this area – the Asian Bond Fund, for example – I nonetheless regard the objective, domestic bond market development, as a high priority.[19]

The third priority item should be to move to still more flexible exchange rates as a way of discouraging procyclical capital flows and permitting the authorities to better tailor credit conditions to local needs. China is the current poster boy for this argument, but it is only the latest example of a country that would benefit from a more flexible rate.[20] Emerging markets as a class would benefit from greater exchange rate flexibility and less fear of floating. Getting there will require putting in place the prerequisites for flexible inflation targeting – an independent central bank, sound fiscal policies, and

[18] See Xie (2004) for a more elaborate discussion of this point. Banks, in contrast, tend to be too easily influenced by their customers – and the government – and in any case they operate in the less transparent, more information-impacted segments of the economy.
[19] See Eichengreen (2004a) for some of these doubts.
[20] Eichengreen (2004b) elaborates this argument. Currently, when the Chinese authorities attempt to clamp down on the provision of bank credit to reduce property market speculation and the danger of overheating, capital simply flows in from abroad and enters the property market through nonbank channels. This is the classic "trilemma" of not being able to have an independent monetary policy when the exchange rate is pegged and the capital account is increasingly porous (whether the authorities like it or not). A more flexible exchange rate would go a considerable way toward squaring this circle.

market-determined interest rates – in countries – like China – where they do not already exist. It will require moving away from outdated commitments to export-led growth in countries like Taiwan and South Korea where the export sector is no longer the exclusive locus of learning effects and productivity spillovers, and where educating and retaining knowledge workers will require a better balance of investment between traded and nontraded goods sectors.[21] In Latin America, it will require measures to reduce liability dollarization and to help countries acquire the capacity to borrow abroad in local currency.

This brings me to my fourth priority, namely measures to address the inability of emerging markets to borrow abroad in their own currencies. While tempted, I am not going to turn this into a lecture on original sin, as the problem is sometimes called.[22] Let me just say that I regard the evidence as overwhelming that institutional and policy reform at the national level will not solve this problem by themselves, at least anytime soon. Stronger policies and institutions help to solve many problems, to be sure, but not obviously this one. Chile has admirably strong policies and institutions, but it still cannot borrow abroad in its own currency. This suggests to me that the problem resides at least in part in the structure of international financial markets. International investors reap limited diversification benefits from adding additional currencies to their portfolios while incurring significant transactions costs from managing positions in relatively small, illiquid markets. The smaller a country, the greater the difficulty it has in getting its currency added to the global portfolio.[23]

[21] That is to say, more investment in universities and housing.
[22] Those wishing one may consult Eichengreen and Hausmann (2004).
[23] For evidence, see Eichengreen, Hausmann and Panizza (2003).

Part of the solution is for the World Bank and regional development banks to borrow and lend in these currencies. Their AAA credit rating permits them to do so with relative ease. The issuance of World Bank debt denominated in pesos will supply the high-quality benchmark asset that investors need in order to price riskier credits. It will increase the installed base of local-currency denominated securities. It will enhance market liquidity. In turn, this will make positions in assets denominated in these currencies more attractive to international investors. From this point of view, the decision of the Asian Development Bank to issue in Chinese yuan, Thai baht and Indian rupee is an important step. We now need the World Bank and other regional development banks to respond in kind.

The fifth and final priority should be to address governance problems at the Bretton Woods institutions. Here my recommendations would run as follows.

$ Increase the share of basic votes and use GDP at purchasing power parity when calculating country size for the purpose of quota calculations. Increasing the share of basic votes will go some way toward restoring the principle of universality and enhancing the representation of poor countries like those of Africa that are frequently the subject of IMF programs, while using GDP at purchasing power parity would enhance the representation of rapidly growing Asian countries.

$ Appoint a single executive director for the European Union. When a version of the document drafted by its constitutional convention is adopted, the EU will be a juridical entity. The majority of its members have a single currency and no more possibility of balance of payments problems among them than there is scope for balance of payments problems between U.S. states. Rationalizing Europe=s board representation will in turn free up chairs for underrepresented countries.

- $ Rely more heavily on the International Monetary and Financial Committee for defining the objectives and strategies of the institution (including meetings of IMFC heads of state, which can substitute for G7/8 summits). This will be possible insofar as the composition of the IMFC becomes more representative as quotas and constituencies are adjusted.

- $ Strengthen the frankness of staff surveillance by creating a presumption that staff studies for Article IV consultations will be published. Revise staff performance assessments to give greater weight to the ability to make independent judgments. Create a presumption that reports of the Independent Evaluation Office will be published.[24]

- $ Finally, base selection of the managing director and deputy managing directors on considerations of technical qualification rather than nationality.

These, in my view, are the priorities. I could go on to discuss other useful reforms, for example in the area of debt restructuring (super-collective action clauses like those pioneered by Uruguay, the usefulness of a Code of Conduct like that suggested by the Bank of France, the value of a standing committee of bondholders) or IMF lending (where there is a need to rationalize and streamline the Fund's lending facilities in order

[24]By further enhancing transparency, these steps will strengthen the accountability of the institution. They will enhance the efficiency of IMF governance by limiting doubts that political pressures, both internal to the Fund and from national sources, are unduly influencing staff assessments. And accountability of the Fund to governments will not suffer to the extent that the oversight of the IMFC is strengthened. They will reassure those who worry that, in the absence of adequate transparency and accountability, a handful of advanced economies have disproportionate influence in the Fund as a result of their personal, political, and intellectual connections.

to make the availability of support more transparent and commitments more credible). I could talk about ideas that I regard as counterproductive (like reviving the SDRM or pushing for the creation of an Asian Monetary Union). But I have gone on for long enough.

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