Bimal Jalan: Seminar on international financial architecture

Remarks by Dr Bimal Jalan, Governor of the Reserve Bank of India, at the symposium of Central Bank Governors, hosted by the Bank of England, London, 5 July 2002.

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Today's topic is a very large one and the time available to us is relatively short. To make the maximum use of the time available to me, I will make four broad points rather than deal with any specific issues relating to the international financial architecture. These, we can deal with later in the seminar during the question/answer period.

The First point that I want to make is that we need to recognize that the period of the 90s, despite many gains, has seen many more financial crises than the earlier decades. The most distinguishing characteristic of this period is a marked increase in volatility in exchange rates and capital flows. The swings in these areas have not only been large, but also unpredictable and unanticipated. Thus, we have seen a large number of currency crises, for example, in Mexico, Russia, East-Asia, Brazil and currently Argentina, Turkey, and emergence of currency pressures in Brazil and Paraguay again. Exchange rates of industrial countries, notably dollar, Euro and Yen have also shown both short-term volatility and large medium-term movements.

Capital flows, particularly to emerging markets, have similarly been volatile, with a boom phase being followed by an abrupt and equally large reversal. Another feature of the abrupt movement in exchange rate is that while crisis initially occurs in one or two countries, their adverse effects can be felt across the world. In the light of the recent events following the Argentina crisis, it is also not clear whether the contagion effect from one country's problems to others has actually been contained, as was assumed only a month ago.

As I said, there have been real gains also in terms of benefits from higher capital flows and more flexible exchange rates. However, it is also a fact that the international financial environment has become substantially more uncertain, unpredictable and unstable in the 90s than in the previous half-century.

The Second broad point that I want to make is that the present international financial architecture, which was designed at Bretton Woods after World War II, was for a different era altogether - one of fixed exchange rates, preponderance of "official" and stable capital flows, and temporary current account deficits which could be met with temporary access to IMF credit. The Bretton Woods architecture was not designed to cope with the instability and volatilities of the kind that I referred to earlier.

Having said this, it has to be recognized that, particularly after the Asian crisis, there has been some progress in strengthening the structure of the old architecture. Various high level forums such as G-7, G-33, G-20 and international institutions such as IMF, World Bank and IOSCO have been busy in analyzing the past experience and in introducing ways and means of imparting greater transparency, early detection, better supervision, higher capital requirements, more sustainable exchange rate regimes, stronger standards and codes, and involving the private sector in resolving crises. Some improvement has also been effected in IMF financial facilities, such as contingency financing facility, to provide quick and higher access in the event of a crisis. However, it is also clear that these efforts, while having improved our understanding of the causes and consequences of financial volatility, and perhaps also helped in devising some precautionary measures, do not amount to a new international financial architecture which can cope with the new realities.

I am also not sure that given the large volumes involved and short period over which a crisis can manifest itself, whether workable international solutions to the weaknesses in the present architecture are feasible within a reasonable time?

My Third point is that today - whether we like it or not - most of the responsibility for coping with the burden of instability and volatility is that of the country itself.

From our own experience in India, I believe that there are three fundamental requirements for a country to prevent a financial crisis:

- Careful monitoring and management of exchange rates without, - I emphasis without - a fixed target or a pre-announced target or a band. Flexibility in exchange rates is essential, but so as the ability to intervene, if and when necessary;
- A policy to build a high level of foreign exchange reserves which takes into account not only anticipated current account deficits but also "liquidity at risk" arising from unanticipated capital movements;
- A judicious policy for management of the capital account. Short-term banking capital for financing investments and growth has to be avoided, while foreign direct investment and portfolio investment have to be encouraged. The point is simply that in respect of foreign direct investment and portfolio investment, there is a "cost" involved for the foreign investor in quickly reversing such flows. This cost is not present in respect of fixed-interest banking capital, particularly short-term capital.

I am glad to inform you that these three broad principles have guided us in India during the 90s in the management of our external sector, particularly after the Asian crisis of 1997. The results have been extremely positive. We have doubled our foreign exchange reserves in the last three years - and increased them several times over since the beginning of the 90s. They are now adequate to take care of all reversible capital flows as well as current account deficits, and are more than required under the conservative "Guidotti rule" (which suggests reserves coverage for one year's capital account liabilities). India's short-term debt is also very low - and Central Bank's forward liabilities have been reduced to less than 1 per cent of reserves.

This has gained us the confidence of the markets. This has been more than evident even during the recent period of uncertainties.

Similarly, we have a flexible but managed exchange rate system. According to the latest assessment by the IMF and other authorities, our exchange rates have been less volatile than other emerging markets. Our exchange rate by any criterion of competitiveness is also believed to be broadly realistic and competitive.

We have also witnessed a substantial increase in capital flows particularly foreign direct investment, and much greater confidence by foreign investors in our macro-economic stability.

Finally, and the Fourth point that I want to make, is that international institutions and international community must play a supportive role in resolving a crisis whenever it occurs. For an agency, such as the IMF, to play such a role, the essential requirements are:

- A substantial increase in its lendable resources in line with increase in the size of international capital flows in the 90s.
- A greater automaticity in the availability of finance, subject to a country following reasonable macro-economic policies. The best way to achieve this objective would be to make IMF facilities "automatic" provided the annual Article IV consultations with the country have been positive and favourable.
- A third requirement is to provide developing member countries with a much larger voting power than now. It is one of the ironies of the last forty years that, although developing countries as a group, have grown much faster than the developed countries and their relative economic strength in terms of output and trade has increased substantially, their actual voting power in Bretton Woods institutions has tended to decline!

To sum up, let us recognize that the present Bretton Woods international financial architecture was not equipped to deal with the problems of instability and volatility in exchange rates and capital flows which have characterized international financial markets in the 90s. Let each country take measures to build its own safety walls by providing for higher reserves, more realistic policies to regulate capital flows, and careful monitoring of exchange rates. Finally, let the international institutions play a supportive role through higher and more automatic access, subject to annual performance review. These institutions must also be made less ideological and less political with greater voice for all member countries rather than for a handful of industrial countries.

[I believe that what I have said is also in line with the "Middle Way" prescription of Mervyn King and is capable of being built into the present architecture.]