Mr Sherwin discusses reform of the global financial architecture from a New Zealand perspective

Address by Murray Sherwin, Deputy Governor of the Reserve Bank of New Zealand, to the International Law Association in Wellington, New Zealand on 9 July 1999.

In October of last year, I gave an address to a meeting of the New Zealand Institute of International Affairs under the title "Asian Prospects and Challenges". That address took place while the effects of the Asian crisis were still unfolding and in the wake of the Russian default, the subsequent collapse and rescue of the LTCM hedge fund, and the associated blowout in global risk premia. Brazil was in strife at the time, and the calls for a substantial overhaul of the global financial architecture were loud and strident. The key themes in that address were that:

- The countries of Asia had suffered a severe shock, and that the initial financial impact would be followed by "real" impacts in the form of declining output and incomes, declining asset values, company failures, rising unemployment along with increasing poverty and social stresses.

- The damage to balance sheets was enormous, with the financial sectors of the worst affected countries carrying capital losses of the order of 25 to 50 percent of GDP. Substantial capital losses had also occurred in the corporate sectors of those countries.

- Those balance sheet holes would have to be filled before any economic recovery could be considered robust. Foreign investment would inevitably have to play a significant role in that task, and would bring other benefits besides speeding the recovery.

- To entice private investors back into the region, it would be necessary to make substantial progress on such basic components of market infrastructure such as accounting standards, audit standards, transparency, the legal underpinnings of bankruptcy law proceedings and commercial law more generally.

- Better risk identification and risk management would be necessary, in both the public and private sectors.

- Asia would eventually recover, but growth would probably settle at something closer to 4 to 6 percent rather than the 7 to 10 percent growth rates of old.

In one sense, the 7 months since I made those comments have shown me to be the perennial pessimist that economists traditionally are. It is not called the dismal science for nothing. Whereas in October, the consensus expectation for the 1999 growth of the six most affected Asian economies was around -0.9 percent, the corresponding number now is +1.1 percent. Recovery has appeared earlier and stronger than I had expected.

In another sense, however, I think my comments of last October remain absolutely valid. The list of prerequisites for robust sustainable growth in Asia is unaltered. And while progress has been made on many fronts, my concern is that the reform process remains inadequate. Indeed, the risk now is that an early return to positive growth is, in some cases, weakening the political will to undertake those still necessary domestic policy reforms. To that extent, the recovery now underway is that much more susceptible to reversal and that much more vulnerable to further crises in the future.

While Asia has been recovering, the debate continues on what caused the crash, and how a repetition can be avoided. If nothing else, the constant shuttling of international bureaucrats to meetings of this "G" or that "G" has kept otherwise empty airlines and hotels in business.

What I would like to do today is survey some of the work taking place under the general heading of "reforming the global financial architecture" and to put some New Zealand perspectives on that process. Note that these are not necessarily the views of the New Zealand Government. Rather they are the views of an individual who happens to have followed the discussion and attended a number of meetings where these issues were under discussion. My comments will be necessarily partial and selective. Why that is so is neatly summarized by Barry Eichengreen (University of California, Berkeley) in a recent publication ("Toward a New International Financial Architecture. A practical Post-Asia Agenda", Institute for International Economics, 1999).

Eichengreen notes that the list of proposals for reform grows longer day by day. Moreover, he notes that:

"Many of these proposals are contradictory and mutually incompatible. Some recommend that policymakers renew their efforts to liberalize international capital markets, while others plump for the reimposition of capital controls. Some insist on the need for greater exchange rate flexibility, while others regard nothing as more important than the re-establishment of stable, even fixed exchange rates between currencies. Some suggest that the international community should respond more forcefully to crises, while others recommend that it stand back and let nature, in the form of the markets, take its course. Some emphasize the need for more funding for the IMF while others call for the abolition of the institution. Some suggest that the Fund must root out corruption and compel countries to install the institutional prerequisites for stable financial markets, while others insist that it should limit its advice to monetary and fiscal policies and refrain from meddling in the internal affairs of its members."

I will quote Eichengreen at length, largely because I find his analysis and assessment as persuasive as any I have encountered on this subject – which is another way of saying that for the most part I agree with him. I am particularly attracted to his dismissal of the more ambitious reform proposals, including those sponsored by some G7 governments, as unworthy of much discussion simply because "They have not a snowball's chance in hell of being implemented. They all assume a degree of intellectual consensus and political will that simply does not exist."

Eichengreen goes on to list a set of key assumptions that condition his thinking on these issues. Those also bear repeating:

- Liberalized financial markets have compelling benefits. This is an argument about savings mobilization, and efficient allocation of investment, together with the benefits of allowing consumption smoothing and risk diversification. Note that it is not a closed-minded piece of ideology, but a proposition that, despite their obvious weaknesses, markets generally do a better job of allocating resources than do governments.

- International financial liberalization and growing international capital flows are largely inevitable and irreversible. At the core of the global trend towards financial liberalization lie changes in information and communications technology. This rapidly emerging and pervasive technological capability makes it more difficult to restrict the range of financial transactions in which market participants engage. As the technology becomes more pervasive, and the benefits from accessing it expand, so too the costs associated with constraints on its use must grow. Moreover, it is difficult to limit international financial transactions when domestic financial transactions are being freed. Given that the case for domestic capital market liberalisation is overwhelming, it follows that it will be increasingly difficult and costly to limit international financial transactions.

- Notwithstanding the manifest benefits of financial liberalisation, capital markets do not work perfectly; they are characterised by information asymmetries that give rise to sharp corrections and, in the worst case, financial crises. Here, Eichengreen recognises that there are characteristics of financial markets that make them prone to occasional distress, to overshooting and to herd behaviour. The banking system will often be the point at which stresses associated with this behaviour come to the surface. So, however positively we view markets, history and the structure of financial markets warns us to expect periodic crises.

- This instability provides a compelling argument for erecting a financial safety net, despite the moral hazard that may result. Eichengreen argues that history shows the need for deposit insurance and a lender of last resort to contain systemic risks to the financial market. He suggests that, by analogy, there is an argument for an international lender of last resort, but muses whether the IMF or any other candidate has the capacity to carry out such a role, or the ability to contain the moral hazard that results. In domestic markets, he argues that moral hazard concerns underscore the need for vigorous supervision and regulation of financial institutions covered by lender of last resort facilities.

It is in this area that I have the greatest reservations about the Eichengreen prescription, reflecting our own aversion to excessive reliance on banking supervision and on well-intentioned, but ultimately self-defeating, financial safety nets. But in accepting his previous point that occasional bouts of financial instability are likely to be a characteristic of deregulated financial systems, we are compelled to consider the need for some means of moderating the impact of those inevitable bouts of instability. Where we differ, I think, is on the potential to push the management of those risks back to the private sector.

- Information and transaction costs prevent decentralised markets from quickly and efficiently resolving crises. Creditors face incentives to run for the exits at the first sign of trouble and, in doing so, are likely to exacerbate any emerging problem. This makes it difficult to orchestrate outcomes that might better preserve value and facilitate its “fairer” distribution. At the national level, insolvency and bankruptcy codes exist which give the courts power to impose restructuring and settlement terms. In Eichengreen’s view, the absence of an international bankruptcy court with similar powers is a problem.

- Economic policy is framed in a politicised environment. This is a very simple but important point. It cannot be assumed that regulators and other economic policy makers will carry out their tasks without allowing themselves to be influenced by political considerations. And mostly, national governments will not cede their sovereignty or control of domestic economic affairs to an international body. That is a reality that should influence any thinking on the list of proposals to reform the international financial architecture.

Pulling all of this together, Eichengreen’s conclusions are “…predicated on the notion that international capital mobility is now a financial fact of life, and the problem for policy is ensure that the benefits of capital mobility exceed its costs rather than pretending that it can be made to go away. They are based on the belief that financial markets can malfunction, creating a compelling case for a financial safety net and therefore a role for the IMF, but also posing problems of moral hazard that must be addressed. They acknowledge that crises will still occur and that there is a need to create institutional mechanisms to overcome the information asymmetries and collective-action problems that prevent them from being rapidly resolved. They acknowledge the existence of political limits…[on the range of policy options].”

With that backdrop, let me turn to the efforts to reform the global financial architecture that are now underway in a number of different international forums. What we can see, first up, is that those with modest ambitions are least likely to be disappointed with what will emerge at the end of this process of reform.

The current list of work underway is summarized in a paper presented in April this year to the IMF's Interim Committee. That paper listed the following initiatives, in best IMF bureaucratese, as "reforms that, at a general level, command broad support."

- To promote transparency and accountability, and to develop, disseminate and monitor implementation of better standards and best practices;
- To strengthen financial systems, including through better supervision, and appropriate mechanisms for managing bank failures;
- To pay greater attention to the orderly liberalization of capital markets;
- To involve the private sector more fully in forestalling and resolving crises;
- To ensure that systemic issues are adequately addressed, including the appropriate exchange rate regimes and the adequacy of the Fund's resources.

The paper also made reference to the essential lead role of the World Bank in developing codes of good practices in social policies and in developing social safety nets before crisis strikes.

To take each of those in turn:

Transparency and standards

Broadly, this looks like being the most significant product of the whole global financial architecture reform effort. The primary initiatives include improved quality, coverage and timeliness of national statistics; improved accounting and audit standards; developing codes of good practice on transparency in fiscal, monetary and financial regulation policies; enhanced transparency within the operations of the major international financial institutions; and improved bankruptcy, corporate governance, insurance and securities regulation. It is mostly unspectacular, quite technical and thoroughly conventional. It aims mostly at sharpening the incentives towards good governance, together with improved risk identification and risk management within both the public and private sectors. Generally it is about ensuring that domestic market and policy structures are compatible with the reality and disciplines of internationally mobile capital.

In general, this seems like thoroughly sensible work. If there are reservations on my part, they relate largely to the risk that international standard setting becomes a substitute for intelligent case-by-case risk assessment. Standards of good practice can too readily become excessively rigid templates which fail to adequately distinguish between diverse circumstances or fail to evolve with changing circumstances. Form can come to dominate substance and, in those circumstances, such standards can become an impediment to sensible risk management rather than an aid. In essence, the risk is that those responsible for the management of banks or other enterprises stop thinking about the underlying risks their businesses face and, instead, become focused on what is required to conform to the regulators' standards.

Strengthening financial systems

A number of different agencies have fingers in this particular pie.

The Basel Committee of Banking Supervisors is reviewing gaps in its existing framework. The work underway includes data related issues, methods for dealing with weak banks, disclosure standards, financial sector safety nets, licensing, governance plus legal and judicial issues. In addition, a review of the 1988 Capital Accord is underway. Banks' dealings with highly leveraged institutions (hedge funds) have also been under review, with an eye to reducing the risk of further surprises of the LTCM type.

The Financial Stability Forum has been established, under the chairmanship of Andrew Crockett, General Manager of the BIS, with the aim of strengthening cooperation among the international organisations, regulatory associations and expert groups with responsibilities in the field of financial regulation and oversight. The core work is taking place in three groups looking at, respectively, hedge funds, off-shore financial centres and short-term capital flows.

The International Accounting Standards Committee (IASC) is completing its work on developing a core set of international accounting standards that could be adopted for international cross-border listings.

The OECD and the World Bank have finalised the development of guiding principles on corporate governance.

The IMF is strengthening its surveillance of countries' financial systems in the course of its Article IV consultations, with a view to improving evaluations of their soundness and vulnerabilities. This is also likely to include reviews of member countries' compliance with the various standards, guidelines and principles referred to.

The IMF, World Bank and the UN Commission on International Trade Law (UNCITRAL) are all working on guidelines for effective insolvency regimes, especially for use in developing countries.

Again, this work falls mostly into the category of good, sturdy but unspectacular. Nothing wrong with that, of course. However, the most important work in the field of strengthening financial systems rests not with the myriad of international agencies listed above, but with the countries now vulnerable to financial crises. The hard effort will be in lifting management quality in banks in the developing and emerging economies, in improving risk recognition and risk management, in improving the regulatory regimes in those countries and improving the quality of regulators and supervisors. And the solution for weak banking systems is not government underwriting. It lies in building structures in which individual banks can be allowed to fail, and in which shareholders can be allowed to suffer losses, without putting in jeopardy the entire financial system of the countries concerned.

To put some particular New Zealand perspectives on these issues, I feel that strengthening the market disciplines on banks and other corporate entities is an important policy objective. Governments cannot underwrite private entrepreneurial activity without encouraging over-investment and leaving themselves vulnerable to subsequent collapses. In the banking sector, the empirical evidence seems overwhelming that government-owned banks are likely to be weakest in risk management. (Depositors assume they cannot fail, because of government ownership. The managers, for that reason, are less likely to be sensitive to deteriorating asset quality). And government-owned banks are most likely to be encouraged into dubious lending for reasons other than sound commercial judgement.

Moreover, you will not be surprised to hear a New Zealander argue that real benefits can flow from a willingness to allow foreign ownership of banks. Those benefits include access to skills and control systems that might not be available locally, the introduction of international business standards into local markets, and reduced vulnerability to inappropriate political influence. Another important element is that the introduction of foreign capital constitutes a useful device for spreading risk in small and narrowly based economies. The consequences of unforeseen shocks are thus rendered less damaging. Well capitalised and reputable foreign owned banks are less likely to fail and have the capacity to bear some of the consequences of a localised shock. If necessary, foreign owners can provide additional equity to support their local banking operation.

Capital account issues

There has been a long-standing presumption within the Western economic orthodoxy that the case for liberalising capital account transactions is essentially analogous to that for liberalising trade. That presumption has come under serious review and challenge subsequent to the Asian meltdown of 1997 and 1998. Recent debates at the Board of the IMF reflect that revisionism, with a new willingness to accept that capital account liberalisation carries risks and needs to be managed. Discussion tends to focus on issues of the speed and sequencing of capital account liberalisation, and on the role and effectiveness of capital controls. On the question of controls, a new orthodoxy seems to be emerging around the distinction between controls on inflows of capital à la Chile (more worthy in some circumstances) and controls on outflows of capital (unworthy generally, although some still see a temporary role in crisis situations).

The on-going work in this area within the IMF relates to reviewing the experience of countries in using different forms of capital controls, and in liberalising different components of the capital account, seeking to draw conclusions for best practices. There is also work underway to improve the reporting and monitoring of capital flows, especially private sector short-term flows related to inter-bank transactions.

As a very small economy, well integrated with global financial markets, New Zealand well understands the concerns some countries have regarding the risks and uncertainties that international capital mobility can pose. But like Eichengreen, I have long since come to accept that capital mobility is just one of the realities of life. Like good food and wine, it can be wonderfully enjoyable – when taken with due recognition of one's capacity to absorb it. But fatal when taken to excess. To take the good food and wine metaphor a little further, the ready availability of essentially endless quantities of gourmet fare simply makes all the more important the qualities of discipline and self-control. It is, of course, possible that the restaurateur will assist you in exercising that self-restraint, but none of us should rely on him to do so.

So it rests primarily with each country to manage its own affairs to gain the undoubted benefits of access to the pool of international savings, while avoiding the damage from over-indulgence. To quote Eichengreen again "… badly managed banks and open international capital markets are a combustible mix. The most direct way of reducing this danger is to strengthen banks' risk-management practices and supervisors' oversight and regulation of those practices".

But that doesn't leave the provider of capital without responsibility, which brings me to one of the most challenging aspects of the current debate.

Involving the private sector in forestalling and resolving crises

By the time the Asian crisis had completed its first lap early in 1998, it had become abundantly clear that, to use a term coined by Michel Camdessus, the world had just witnessed "the first financial crisis of the 21st century". Camdessus was acknowledging that the Asian crisis was different from those that the IMF had grown accustomed to dealing with over its first 50 years. No longer could the IMF assume that failures of macro-policy, primarily monetary and fiscal policies, would lie at the core of every crisis. Instead, Asia represented essentially a crisis of the private sector. I think that is an important part of the explanation for why the IMF found it so difficult to respond to the Asian crisis, and why its critics contend so vigorously that the IMF "got it wrong" in Asia. In essence, the Fund was confronted with a set of problems that were, in many respects, new and unfamiliar.

If the origins of the Asian crisis lay in the private sector, what of the solutions? I think one important conclusion that flows very readily from the Asian experience is that raising large scale public funding for rescue packages, as occurred in Thailand and Indonesia, and was done more in "virtual" form for Korea, will be difficult to repeat in the future. This is particularly the case where funds raised from the taxpayers of the international community are seen to be going mostly to facilitate the escape of private investors from investments that have turned, for whatever reason, to mush. For that reason, the question of “bailing-in the private sector” has been a topic of intense debate amongst those who think about international economic crisis management. This term covers a range of suggested measures by which the private sector would be obliged to take a share of the downside risk of cross-border investment activities.

I won’t dwell on the particular proposals that have emerged. In general, there seems to be broad acceptance of the principle that private investors should bear their fair share of the risks. However, just what that means, and how that might be achieved are questions of enormous complexity. A key issue, it seems, is that emerging countries are often in favour of the private foreign investors sharing risks (ie, taking some losses when trouble strikes), but many seem reluctant to face the prospect of increased cost of funds, and/or reduced supply of foreign investment, that will be associated with contracts that put more risk on the investor. That is both unfortunate and misguided. Any increased costs should be viewed in the same way as an insurance premium – the price paid for reduced risk.

There is a great deal that can be done to make countries less vulnerable to volatile capital flows – and coincidentally, to reduce those insurance costs. These include:

- Avoiding an accumulation of short-term debt and ensuring that reserves and banking system liquidity are adequate to provide a significant buffer against a disruption in investment flows.

- Avoiding “off-balance sheet” transactions or loan contract clauses that have the effect of allowing the lender to withdraw funding at short notice.

- Exploring the possibilities for private contingent credit lines that provide additional liquidity, or reduce debt service burdens, at times of stress.

Also, some degree of consensus seems to be emerging around the need to re-assess the capital standards established by the Basel Committee on Banking Supervision with a view to reducing the perceived bias towards short-term interbank credit lines from industrial countries to emerging market banks.

In addition, there is a great deal of work underway in exploring the possibilities of modified bond contracts. This is aimed at making it easier to manage a restructuring of bond terms, for example, to lengthen the maturity or defer interest payments temporarily, in the event of a crisis.

Systemic issues

Under this category comes research work to better understand the implications for economic policy makers of the globalisation of the international monetary and financial system. A key area for attention is that of exchange rate regimes, the impact of exchange rate volatility and how best to manage the inevitable swings in capital flows.

I believe that much of this work will end up focusing heavily on strengthening financial systems – stronger balance sheets with more equity, improved risk recognition and risk management, stronger accounting and audit standards, increased transparency and improved standards of banking supervision. This is all aimed at providing a more stable basis for cross-border investment flows rather than trying to act directly to stabilise or control those flows.

Also under the “systemic issues” heading comes work on developing the IMF’s capacity to respond to crises. We have already seen the new Contingent Credit Line (CCL) introduced. Personally, I see very little merit in this, and many dangers. For the IMF to be recommitting to support particular countries simply raises the stakes when policy quality deteriorates to the point where the Fund should withdraw that pre-commitment. It also implies that when faced with capital flight, access to additional funding is a key part of the required response. The risk, or course, is that access to additional funding simply further defers the necessary policy and asset price adjustments, and makes the subsequent collapse all the more expensive.

In addition to the CCL, the IMF now has access to the NAB funding, which together with the GAB gives it around US$ 46 billion in available resources for crisis management. It now has its 11th quota increase in place as well, which lifts total quotas from around US$ 200 billion to US$ 290 billion.

The unfinished debates relate to the role of the IMF and World Bank going forward, issues of representation at the key policy forums – the old established structures now in place in bodies like the IMF and its Interim Committee now look to be thoroughly out of synch with the current global distribution of economic weight. For all of that, as the G22/G33 progression showed, the old order is not yet ready to die.

APEC

My final comments on this territory relate to the place of APEC in this territory. Much of the debate I have covered will emerge in a variety of guises within the APEC Finance process. This is primarily the responsibility of my Treasury and MFAT colleagues, rather than the Reserve Bank, so I will step only lightly here.

The New Zealand priorities for the APEC Finance Ministers process will focus on three key themes:

- Open robust economies
- Credible, effective processes, and
- Strong global economies.

Under the first of these, finding ways to encourage the development of strong financial markets within the APEC group is a key to meeting the long-term goal of open markets. APEC will not be looking to duplicate work already taking place under the various umbrellas I have referred to. But it can draw on that work, and use processes such at individual action plans (IAP's) and voluntary action plans (VAP's) to give it momentum within APEC.

New Zealand is promoting a VAP on Supporting Freer and Stable Capital Flows. This is split into two parts. Part 1 is an information-gathering phase and has already started. It includes some work being commissioned from the IMF on countries' experiences with capital account liberalisation (including the efficacy of capital controls as a transition measure), a PECC update of a 1995 survey of impediments to investment within each APEC economy, and an ADB study of the role played by capital in the economic development process along with work on reform sequencing. I understand that Part 1 is intended to be completed in the next year or so, with a synthesis of the various studies being submitted to APEC Finance Ministers in September 2000.

Part 2 is intended to take the form of Voluntary Action Plans by individual APEC economies, drawing on the wisdom distilled in Part 1. An initiative on strengthening financial markets is being developed as a pilot of part 2 of the VAP. This initiative will involve pulling together the relevant international standards in the area of financial markets, as reference points for economies to self assess the adequacy of their policies and to identify future reforms, and as a basis for peer review within APEC. This initiative will focus on such matters as banking supervision, payments systems, corporate governance and disclosure standards. This initiative will be discussed further at the APEC Finance Deputies' meeting in Wellington in August.

The issue of developing domestic bond markets has also been prominent on the APEC Finance Agenda. Guidelines of best practice in this field are being developed for preliminary discussion in August. The objective here is to encourage APEC economies to remove the impediments to the development of domestic bond markets, in recognition that some economies are very dependent on the banking system for funding.

Other areas of work involve, for example, the ADB efforts to coordinate a project aimed at boosting training for APEC area banking supervisors and securities market regulators and some useful work already undertaken in the field of corporate governance.

APEC represents an interesting grouping of economies, with diverse experience and diverse circumstances. Hopefully, New Zealand can apply its time in the chair to help focus the APEC discussion on reform of the global financial architecture. If we are successful, we can ensure that APEC is an effective "outreach" mechanism providing cogent, well thought through and influential commentary to the G7, IMF and other key forums considering the architectural issues.