Juergen Stark: Reform propositions and the shaping of a new financial architecture

Remarks by Mr Juergen Stark, Deputy Governor of the Deutsche Bundesbank, during a panel discussion at a conference, “International financial architecture: recent issues and alternatives of reform”, organised by the Konrad Adenauer Stiftung and the Brazilian Institute of Economics-Getulio Vargas Foundation, Rio de Janeiro, 26 June 2001.

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I

To state my standpoint in advance: I myself do not believe a completely new financial architecture to be necessary. I tend to be one of those people who do want to improve the free market economy system, but who also want to preserve that which has stood the test of time. Much would already be gained if free market and institutional rules were to be applied more consistently.

II

There cannot be any therapy without a preceding diagnosis. We have to find out what went wrong, and why, before discussing the remedies. The recent crises have undoubtedly revealed the shortcomings of the system. As I see it, in every case – despite all the individual differences – these were due to a mixture of economic policy errors and inadequate underlying conditions.

In almost all the recent crises, <u>the economic policy errors</u> seem to have been the same:

- a long period of fixed exchange rates (followed by a loss of external competitiveness, a rise in interest rates, a considerable set-back in growth rates, and a devaluation of currencies);
- an increase in inflation rates;
- and increasing budget deficits.

This problem was addressed by the Bundesbank in a research study which it published in its April 1999 Monthly Report. The Bundesbank based its research on econometric procedures, applied to developments in major emerging markets over the past 25 years. The main conclusions reached by the study were

- that currency crises are not the result of pure chance or pure speculation;
- that economic fundamentals play an important role;
- and that, in particular, in the year preceding the outbreak of a crisis, the macroeconomic indicators deteriorated perceptibly;
- on the other hand, although there is a systematic link between fundamentals and crises, the indicators are not able to forecast a crisis in each and every case (there may be warning signals not followed by a crisis, and there may be crises not preceded by signals).

These conclusions are quite important for crisis prevention. Above and beyond that, whether undesirable economic policy developments expand into a crisis or not hinges mainly on <u>shortcomings in the underlying conditions</u>. These include

- weak financial sectors;
- tendencies towards nepotism, cronyism, and corruption;
- distorting bail-out expectations on the part of market participants, including moral hazard;
- insufficient information on current developments;
- insufficient surveillance by the IMF and contradicting actions by other institutions;
- a disregard of advice and agreements, accompanied by poor co-operation with the international organisations.

III

What are my reform proposals and how should the “financial architecture” be shaped? Let me start with the design of economic policy. This is clearly a matter of the financial architecture as far as the fundamental characteristics are concerned.

First of all: the exchange rates. The very interesting fixed-versus-floating rate debate is an issue on which there is no simple “yes” or “no” answer. The choice of an exchange-rate system can only be judged with reference to a country’s state of development, its economic benchmarks and its political circumstances.

Experience suggests that stable exchange rates are generally desirable. In some special, well-defined cases, exchange rate pegging can be useful in getting domestic inflation under control and in maintaining financial stability.

In the long run, however, a country that has given priority to pegged rates must ascertain whether or not it can keep its internal flexibility sufficiently high to enable it to make all the necessary adjustments. In particular, with priority given to fixed rates, monetary policy has to be completely subordinate to the exchange-rate target. Moreover, there is not much room for budgetary policy. It has to be conducted in a stability-oriented manner in order to keep up domestic and external confidence. Thus, a stable exchange rate is only sustainable if the corresponding fundamentals are adequately streamlined. A pegged currency alone cannot guarantee market confidence on a lasting basis.

On the other hand, if the fundamentals of a country are fairly sound, and, in particular, if monetary policy can be conducted on the basis of an "own" nominal anchor (i.e. independently, with a strong sense of responsibility and a firm view of stability) a floating exchange rate may support the necessary adjustments of a country that is emerging into an advanced economy. In general, with a floating rate, the room for manoeuvre will be larger. But be careful: flexible rates are not a panacea, they are not a substitute for keeping your house in order.

It may be asked at this point whether European monetary integration can be a model for an emerging region. There is no simple answer to that. In my view, one has to be aware of mainly three points: Firstly, the decision to adopt a single currency is inevitably a political one. Secondly, a monetary union cannot be a cure for otherwise deficient economies. And thirdly, a monetary region clearly requires internal openness and implies convergence and intense competition. Some radical adjustments may be necessary.

IV

My next point: the liberalisation of capital movements.

In principle, the fact that the free movement of capital contributes to the optimum allocation of resources is not open to question. But that must not imply liberalisation at all costs.

One important conclusion from recent crises is that the focus on so-called “sequencing” has to be strengthened. That means: further liberalisation only in those countries where the financial markets and, in particular, the banking system have a sound structure and are in a healthy condition. Knowing the risks, it would be irresponsible to take the second step before the first.

On the other hand, there is no doubt, from my point of view, that capital controls are not a realistic alternative to open capital markets. The reintroduction or maintenance of administrative controls in an otherwise liberal environment poses fundamental problems.

Firstly, market participants will always contrive to avoid such controls and, if anything, they are more imaginative than the controlling authorities.

Secondly, capital restrictions are very expensive to implement in most cases. To be effective, they must be applied quite broadly and may therefore also hinder desirable capital movements. What is more, they may also delay the necessary development of an efficient financial sector.

However, this does not completely rule out the possibility of considering temporary restrictions in exceptional cases. Limited controls on capital inflows can help to prevent crises by confining potential withdrawals. Such controls, however, can only be efficient if they are clearly understood as an interim measure, and if they are complemented by sound policies and well-designed prudential regulations.

V

As far as the underlying conditions are concerned, allow me here to point out only those that continue to be critical or especially fraught with problems: standards and codes, transparency, conditionality and ownership, private sector involvement, and institutional co-ordination.

But first of all, let me come back to the topic of financial supervision. I think, adequate supervision is the sine qua non of a robust system.

- If the rules for balancing the inherent risks in assets with the domestic and foreign resources are insufficient, they encourage an inappropriate allocation of assets and the banking system becomes inefficient;
- foreign debt should be adequately structured to worst-case scenarios, which – sooner or later – may occur in almost any country;
- the maturity structure of banks' foreign liabilities should not be dangerously biased toward short-term positions, and the denomination of liabilities in foreign currencies can be rather risky in the face of domestic currency assets (withdrawals can lead to collapse).

Let me say this: With more prudent banking structures and more appropriate supervision, capital inflows and investments are more realistic, and closer to an optimum. Actual crises could be mitigated or even be avoided. By the way, I do not think that banking supervision has anything to do with restrictions or over-regulation. On every highway we need a highway code, and in the cities we need a certain minimum number of traffic lights. Otherwise, movements could end up in disaster.

VI

Now to "transparency".

This is the area in which there has probably been the greatest change over the past few years – not only in the case of the international institutions, but also in the countries themselves. There has been a significant expansion in the publication of surveillance reports and in the disclosure of information on lending.

For improving financial market transparency, it is in fact important that comprehensive information be made available and be analysed and evaluated thoroughly. Data contribute to stabilising the global financial system. They strengthen the operational efficiency of the markets, investors are better able to make appropriate risk assessments, and, hopefully, the contagion risk and the associated herd instinct will be reduced.

All this is clear. Again, however, let me signal some warnings:

- Transparency should not work counter-productively. It should have its limits where confidentiality and internal openness are indispensable to fruitful discussions and optimal results.
- Moreover, as indicated above, one has to be very careful with detailed information that may perhaps be evaluated carelessly. And the IMF should abstain from commenting on each and every number. There is no guarantee that certain indicators always give the right signals, and a crisis could be triggered that would otherwise not have taken place.
- Too frequent information may favour short-termism, and interfere with the economic culture. Permanently looking at short-term profits, for instance, may be counter-productive in the longer-run.
- Last but not least, I sometimes have the feeling that we do not have a lack of information but an abundance. In fact, staffs have to spend some time in sorting out useful from useless information (and sometimes produce new papers with even more information).

VII

On "standards and codes" in general: This is a complicated matter.

On the one hand, it is probably correct to say that the recent currency crises were due, at least in part, to careless or "immature" patterns of behaviour. In that respect, standards and codes set criteria and require the countries to "behave correctly". The basic idea of drawing up "rules" and of thus making the interaction on the internationally linked markets easier, predictable and perhaps also more "just", is surely not wrong either. I give my full support to such rules if they serve the efficiency of the markets (for instance: eliminating corruption and combating money laundering).

On the other hand, there are problems which might hamper the desired success:

- There are now more than 60 standards and codes. Over 10,000 assessments would have to be prepared in order to monitor them for all 183 IMF countries. This simply cannot be managed. Besides, the cost would be out of all reasonable proportion to the benefit.
- Not all standards and codes have a relation to economics. For that reason, too, priorities have to be set.
- Furthermore, there is not always a compelling reason for everything having to be done in accordance with one given standard. Is that really an indispensable precondition for the markets to function efficiently?
- It is also difficult to answer the question of whether there really have to be rules that may well enhance efficiency but perhaps ignore cultural diversity as well.

Thus, my conclusion at this point is: We have to be careful, we should not carry things too far, and not at all costs.

VIII

After “standards and codes”, the logical next topic is <u>“conditionality and ownership”</u>. As we all know, the IMF has always been subject to criticism that it sets conditions for its lending that are too demanding, that it "imposes" its programmes, even that it puts a "gag" on the borrowing countries and restricts their sovereignty.

Some of that criticism is justified. It is, in fact, counterproductive if the borrowing country is not sufficiently involved, if its priorities are not taken into account and if programmes are so detailed that the country in question no longer has any freedom of action. In that respect, the IMF was on the wrong path. Things are changing at present, however. I fully support the strategy of focusing in future more on the objectives of securing the borrowing country's ownership and of dispensing with detailed requirements for implementation (technical assistance should continue however).

But let us not deceive ourselves: The freedom of a patient is limited in any case. It may become even smaller, if the IMF keeps out completely. The constraints of the facts may be overwhelming. Diseases are likely to take their toll. On the other hand, there is certainly a realistic chance that healing powers are at work. These powers, however, have to be actively supported by the patient (with or without the IMF).

IX

Much has been done with regard to <u>“private sector involvement”</u> (PSI). But we have not yet arrived at final conclusions. Sometimes it seems that this is only a matter of crisis solution. In fact, however, it is not. It is, in my view, predominantly a matter of crisis prevention. That is because the manner of operating in the event of crisis has a crucial influence on expectations. These, in turn, determine the actions of investors at a very early stage and thus the scale of the risks and of susceptibility to crisis.

Short-term financial assistance from the IMF in the event of crisis may be essential, both for the countries directly affected and, as a result of contagion, for the rest of the world. A regular bail-out of the private sector, however, is likely to be counter-productive:

- It may have a detrimental effect on the risk-awareness of private investors and obscure the optimal allocation of resources;
- large-scale financial packages may support unsustainable exchange rates;
- large-scale financing by the IMF brings about financial burdens that cannot be covered by the Fund’s resources;

- and, last but not least, endless financing may encourage resistance to the implementation of reforms.

My conclusion at this point: The role of the IMF should be predominantly a catalytic one. For that purpose, the Fund's main instruments should be convincing advice and programmes, not money. Priority has to be given to the private market participants. The leitmotif of the Fund has to be "bail-in", not "bail-out".

Admittedly, it is not easy to find the right balance between "bail-in" and the avoidance of contagion. Now, there are some fresh ideas from Lerrick and Meltzer. They propose, as I understand it, that markets should more or less be left alone in the event of crisis (bail-in), but that, nevertheless, the Fund should offer a minimum safety net to avoid panic (by purchasing private creditors' assets at a well-defined discount). At first sight, this looks good. I suspect, however, that we partly shall have the same deficiencies here as mentioned above – only in a new wrapping.

X

My last point, although it is no less important, is "institutional co-ordination". Activity by private market participants is fine, but it is not sufficient. We need some public activity to organise the legislative basis and to provide other public goods in order to maximise global benefits.

Let's look at the IMF and the World Bank. There have been many suggestions for improving their effectiveness, from merging these institutions to abolishing them altogether. I cannot say that I particularly like those extremes.

Rather, in a changed global economic setting, the IMF needs a clear mandate. This applies as much to crisis problems as its does to demarcating the IMF's institutional role vis-à-vis the World Bank.

The roles of the IMF and the World Bank need to be strengthened. They should act as advisers on macroeconomic, structural and development policy issues, but their role as lenders should be limited to that of a catalyst. These objectives are consistent with the Articles of Agreement of both the IMF and the World Bank and take due account of the changed environment since the Bretton Woods institutions were set up: floating exchange rates, liberalisation of capital movements, globalisation of markets, and heightened awareness of poverty problems.

The IMF is designed as a monetary institution, whereas the World Bank is a development organisation. A blurring of their responsibilities is just as undesirable as a merger of the two. The implications for lending have to logically follow from that division of responsibilities. The IMF should confine its balance of payments funding to short-term liquidity assistance. The World Bank should focus on project financing and sectoral loans. This would involve a redistribution of tasks between the IMF and the World Bank: the IMF should at least confine its long-term structural loans, and the World Bank should avoid participating in crisis packages. Moreover, combating poverty is a development policy objective and therefore comes within the purview of the World Bank. The IMF plays its own part in combating poverty by fostering monetary stability and thereby contributing to non-inflationary sustainable growth.