David Dodge: International financial architecture and the resolution of financial crises

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I am pleased to be here today to talk about the Bank of Canada's contribution to international financial stability and the resolution of financial crises.

The preamble to the Bank of Canada Act calls on us to promote the economic **and** financial welfare of Canada. In this context, we aim to foster good economic performance through monetary stability—that is to say, through low, stable, and predictable inflation. But no market economy can function properly unless it is also supported by an efficient and stable financial system. Sound financial institutions, a robust infrastructure, and well-functioning financial markets are necessary to facilitate transactions and to properly channel savings into investments.

This is true for Canada's domestic economy. But in today's interconnected world, it is equally true for the global economy. Recent experience has shown that world events can have serious repercussions on national financial markets, including ours, and indeed on our entire economy. The Mexican crisis of 1994–95 and the Asian and Russian crises of 1997–98 are cases in point. In both instances, Canada was sideswiped. And while the recent acute economic and social problems in Argentina have not had a major economic impact beyond that country's borders, they have nevertheless had implications for Canadian banks operating in, or holding claims on, Argentina.

So Canadians have more than a passing interest in a healthy global financial environment. Sound macroeconomic policies and sound financial systems across all countries are becoming even more important as the world becomes more and more integrated.

The episodes of financial stress that the world has experienced in recent years have revealed weaknesses in the foundation of the international financial architecture. Those problems have to be addressed, and the foundation fortified, if we want to reduce the incidence and the impact of global financial disturbances.

In the aftermath of the crises of the late 1990s, the international community has acted to identify and to begin to deal with financial vulnerabilities.

Canadians have been actively involved in this work. And we at the Bank of Canada have played our part. The Bank participates in several international forums where issues of financial stability are being debated. And we work closely with others to strengthen the international financial architecture by developing frameworks for the prevention, management, and resolution of crises.

Today, I would like to update you on some of the progress that has been made to date and on what remains to be done. But before doing that, it is important to briefly review the lessons we have learned, or ought to have learned, from recent financial disturbances.

Crisis prevention—lessons and progress

What are some of the factors that led to the serious problems experienced by Mexico, a number of Southeast Asian countries, Russia, Brazil, and, more recently, Argentina?

In various combinations, there were large current account and fiscal deficits, heavy reliance on short-term borrowing, weak banking systems, poor risk management, overvalued exchange rates, and lack of transparency in fiscal, monetary, and financial policies. Moreover, the presumption that the international community would come to the rescue if things turned sour, appeared to offer some form of protection to emerging-market borrowers and lenders. This distorted market signals and encouraged overborrowing and overlending.

So what has been done, and what can be done, to minimize the risks of future crises?

A sound macroeconomic policy framework

It is now broadly recognized that sound and credible macroeconomic policies are the best defence against financial crises. As we know from our own experience in Canada, this means a fiscal policy focused on keeping public sector deficits and debts on a sustainable track and a monetary policy focused on keeping inflation low and stable.

A viable macroeconomic framework for growth requires that both fiscal and monetary policies be credible. But many emerging-market countries lacked credibility. To provide an anchor for their policy framework, they chose to peg their currencies to another major international currency or a basket of currencies.

But a peg can only provide temporary credibility. And when countries fail to develop appropriate fiscal, monetary, and regulatory policies, even small economic shocks can put pressure on the peg. Markets can then begin to question the authorities' commitment to the peg, and domestic and foreign investors can rush for the exits, triggering a crisis. In fact, that is exactly what happened in those economies that ended up in trouble during the past decade.

So, many of these countries were forced to abandon the peg as an anchor and had to opt for a flexible exchange rate. But an anchor is still needed. Otherwise, the freedom of the currency to float could undermine confidence in its value, both at home and on world markets. Targets for domestic inflation provide such an anchor for the currency.

In the last few years, a growing number of emerging-market economies have moved to flexible exchange rate regimes, and have also adopted inflation targets. In several cases, Canada has played an important role in that process. Because of our long experience with flexible exchange rates and our strong reputation in inflation-targeting, several emerging-market central banks have asked for the Bank of Canada's assistance in developing and operating frameworks based on inflation targets.

A robust financial infrastructure

Another important lesson drawn from recent crises is the need for a strong financial infrastructure.

Weak banking systems were at the heart of nearly every one of the recent financial crises. To perform well their important role of intermediating between lenders and borrowers, banks and other financial institutions need to work within a strong framework—a framework distinguished by clear accounting and disclosure standards, appropriate regulatory and supervisory practices, and well-defined bankruptcy rules. In many cases, these institutional arrangements were found wanting.

The international community has done a lot to contribute to the strengthening of financial systems in emerging-market economies and to improve risk management in major industrial countries. International groups, such as the Bank for International Settlements (BIS), the International Monetary Fund (IMF), the Group of Twenty (G-20), and the Financial Stability Forum (FSF), have worked hard to establish globally accepted guideposts—codes and standards—for the sound operation of financial institutions and systems.

But guideposts are not much use if they are not followed. So it was also essential to develop the means for assessing adherence to key standards and for public disclosure of important economic and financial information. If there is a lasting lesson in recent history, it is that we need greater transparency. Better and more timely data should lead to more informed judgments about how risky certain investments are. And this should help avoid the crises that can be set off by the sudden revelation of problems.

As I said earlier, the Bank of Canada and the Government of Canada have fully participated in, and contributed to, many of these initiatives. I would highlight, in particular, our involvement with the FSF and with the G-20, until recently chaired by Finance Minister Paul Martin. The Office of the Superintendent of Financial Institutions and provincial securities commissions have also been working with the FSF and with the BIS to identify system-wide weaknesses and to develop worldwide financial standards and codes.

The Bank of Canada, together with the Bank of England, has also been promoting the idea of clear, upfront limits on official lending (that is, lending from international financial institutions, such as the IMF) as a means of conditioning the expectations of creditors and borrowers and thus helping to prevent crises. I will have more to say about this in a moment.

Before I move on, let me add that, in the context of assessments of how well countries are doing in strengthening their financial systems, Canada was the first industrial country to place its financial system under IMF scrutiny. And we passed with flying colours. Of course, this does not mean that we can afford to rest on our laurels. On the contrary, it is vital that we continue to look for ways to improve the efficiency and soundness of our national financial systems.

Crisis management and resolution: a work in progress with lots still to do

As you can see, important preventative actions have been taken to reduce the risk of future crises.

But of course, even with the best preventative efforts, we will not totally eliminate the possibility that, from time to time, there will be a crisis in some part of the world because of one shock or another. As I said before, when there is a shock, national macroeconomic policies must be adjusted in response. But this takes time. And where policies are not particularly credible and markets are getting jittery, the prospect of adjustment down the road may not be enough to restore confidence in the short run. So domestic and foreign investors and creditors may have a strong incentive to pull their funds out of the affected country. This could precipitate a crisis.

If creditors can be encouraged to stay put and to negotiate a solution in an orderly fashion, it would be in their collective interest as well as that of the whole international community. But how can this best be accomplished?

This has proven to be a rather contentious issue, with the debate centered on the proper roles and responsibilities of the official and private sectors in crisis management and resolution. The key question here is how much emergency assistance should be presumed to be available from the official sector and how much should be left for private debtors and creditors to sort out by themselves.

Traditionally, the IMF has been the main provider of emergency official assistance to a country that runs into financial difficulties. But IMF resources are limited. And when debtors or creditors presume that there will be large official bailouts, there is the possibility of "moral hazard"—debtors have less incentive to make adjustments, and creditors feel less pressed to use effective risk management. More importantly, with no limits on official money, there is less motivation for creditors to be careful with risk assessment when loans are made. And there is little motivation for early, serious discussions between a debtor and its creditors when problems begin to arise. In fact, the only serious motivation comes when the crisis is full-blown and official money runs out. Clear limits would encourage better risk assessment, earlier negotiations, and conceivably, a quicker and more orderly resolution of the crisis.

Of course, one could eliminate official assistance altogether and leave debtors and creditors to work it all out on their own. But with no official lending, disorderly defaults could occur more frequently, resulting in unnecessary output losses and financial-system disruptions in the affected countries and elsewhere.

Over the past couple of years, the Bank of Canada and the Bank of England together have developed a "middle ground" approach, designed to encourage private lenders to work closely with debtors to find timely, orderly solutions.

In our joint work with the Bank of England, we set out a framework for the resolution of international financial crises. This framework has three basic elements. First, official assistance should be limited, and the limits should be well known in advance. (These limits are often referred to as the "presumptive limits.") The second key element of our approach is the possibility of exceptional official lending in the unlikely event that a crisis threatens global financial stability. But such lending would be based on explicit criteria and procedures. Third, it is recognized that, under certain conditions, an orderly standstill (that is, a temporary suspension of debt-service payments) may be appropriate to give distressed debtors some time to take steps, including debt rescheduling, to address their problems. In addition, the framework encourages greater use of what is known as "collective-action clauses." These clauses are intended to discourage "rogue" creditors from blocking or rejecting a reasonable offer for debt restructuring.

Such a framework, by providing greater clarity upfront about the size and terms of the official assistance available, allows debtors and creditors to form more realistic expectations. In so doing, it helps to prevent crises; and, should they occur, it creates the right incentives for their timely resolution.

In many international forums—IMF, G-20, G-7—Canada has been working hard to encourage the adoption of such a framework. And last month, G-7 finance ministers and central bank governors adopted an Action Plan that aims to address many of these issues. The current problems in Argentina have served as a catalyst to refocus the attention of the international community on what was needed "to increase the predictability and reduce the uncertainty about official policy actions in the emerging markets."

The G-7 Action Plan identifies the key elements of a successful framework for crisis prevention and resolution, and how these elements fit together to help align incentives for debtors and creditors. First, it recognizes the need for limits on official lending. Second, it recognizes the need for rules in loan contracts to allow a cooling-off or standstill period and prevent small groups of creditors from blocking a reasonable restructuring deal. The Plan also encourages the IMF to continue its important work to find some mechanisms for sovereign debt restructuring analogous to domestic corporate bankruptcy procedures, such as Chapter 11 in the United States and the Companies' Creditors Arrangement Act (CCAA) in Canada.

The G-7 countries have pledged to work with borrowers and creditors to make sure that these ideas can be effectively put into practice. Clearly, a lot more needs to be done, including work on operational and legal issues. But let us not lose sight of why this work is important. The Action Plan, by helping to reduce the incidence of financial crises and to better resolve them when they do occur, will create conditions that encourage sustained and sustainable growth of private investment in emerging-market countries, thus helping to raise their living standards.

Concluding thoughts

To conclude, considerable progress has been made in defining the elements of a strategy to reduce the incidence of crises in the future.

When it comes to crisis management and resolution, the international community is still hard at work. Many issues on how to put in place a framework for promoting orderly debt restructuring remain outstanding. But significant progress is being made.

The stakes are high—not only because of the economic costs, but because of the social costs and the human suffering caused by financial crises. And, in an increasingly integrated world, more than ever, we are all in this together.