Klaus Liebscher: International institutions and financial market stability

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Ladies and gentlemen, today's liberalized and universal character of financial markets and capital flows has made it impossible for even the strongest national states to handle the governance of global finance on their own. Thus, various networks of intergovernmental consultation and cooperation have developed in parallel with the accelerated globalization of finance during recent decades.

Ensuring financial market stability can, therefore, be regarded as a global public good. This rests on the simple observation that banks and other financial institutions operate in many different jurisdictions very often without due cognizance of the consequences they may create. This requires that international agreements, cooperation and coordination ensure international public control, so that negative externalities such as systemic risk or the possible negative impact on economic growth due to financial instability are prevented as far as possible. In addition, international cooperation helps to ensure that a regulatory "level playing-field" exists such that the possibility of regulatory arbitrage is avoided. International financial integration and its governance thus implies that central banks and other national authorities have to develop policies that foster financial stability not only on a domestic but also on an international level. Let me give you an example to underline my point by referring to the tragic events of 9/11. Without cooperation between the Eurosystem of Central Banks, the Federal Reserve and other international central banks, we may, indeed, have had a very negative impact upon the international financial system and even worse repercussions on global growth.

In the past decades, an impressing number of policy measures and initiatives have been made on the European and the international level to govern issues of financial market stability and - in a broader context - of economic policy. On an international level we witnessed efforts to achieve global convergence in what are considered "good economic policy measures"; on a European level Monetary Union represents a very successful model of inter alia instilling stability into the financial system; hard work has been put into forward-looking measures to prevent crisis in the financial system like Basle II or the IMF's Financial Sector Assessment Programs (FSAPs).

Let me outline a few of these international efforts in coordination and cooperation in more detail to you.

Convergence of economic policy measures

The meetings of international economic policy makers in the various institutions and fora have produced a remarkable convergence of ideas concerning domestic economic management. The general approach to economic management within developing, emerging, and transition economies as well as within the industrial world can perhaps be summed up as "macro-economic stability and supply-side flexibility". These objectives pertaining to both monetary and fiscal policy were agreed to at the 1994 Annual Meeting of the IMF in Madrid.

The emphasis since then is on price stability as the immediate goal of macro-economic policy. This is not simply an end in itself but measures the balance between aggregate demand and underlying supply in the economy as a whole. In effect the aim of monetary policy in particular is to moderate, rather than aggravate, the economic cycle, and so to provide the basis for sustainable growth at around the underlying rate of potential growth. In relation to fiscal policy, the emphasis is to limit public sector borrowing, and the outstanding level of public sector debt, to levels that can be sustained into the medium and longer term without the need for increasing taxes or the imposition of rising real interest rates. You will have noticed that these principles, already formalized before the Madrid Declaration, are also the ones underlying European Monetary Union.

This aim of macro-economic stability brings into sharper focus the structural, supply side, of the economy. Here, too, there has been a strengthening international presumption in favor of open markets and free competition - both domestically and internationally - with a continuing strong presumption against predatory trade or the use of competitive devaluation. The justification is that undistorted competition contributes to potential global economic growth through increased efficiency and the more effective allocation of productive resources. Faster growth in turn provides a more favorable context for addressing social concerns, including the issue of poverty.

Monetary Union: the European dimension

With the introduction of the euro, the economic weight of the single market has risen to a level matching that of the USA. And the single currency has gained an important international dimension: The euro segment of the global money market has risen to about 25%. In the bond market, too, the euro plays a crucial role in fostering a deeper and more liquid market. The introduction of the euro paved the way for issuers to access a broader base of investors.

Investors too have gained access to a wider spectrum of investment opportunities. The euro’s share in net issuance currently amounts to 39%. Regarding its use as an official reserve currency, the euro has already attained the same weight as its predecessors.

Within the euro area, Monetary Union has kept member countries from being exposed to harmful intra-European exchange rate tensions of the type that many countries used to suffer when external shocks occurred. It has become quite obvious that Austria’s inclusion in the stability-oriented Economic and Monetary Union has protected our country from negative shocks much more adequately than was possible under past regimes. Moreover, the almost four years of EMU bear impressive testimony to the fact that the stability-oriented interplay between monetary and fiscal policy provides a solid foundation which was well suited to weathering the economic policy challenges of this period.

With the euro the EU successfully supplies an important international public good in the form of a stability anchor with deep and attractive financial markets. This is especially relevant with a view to enlargement of the EU. European integration will only be truly successful if it reaches out to the whole of Europe. If the EU manages the enlargement process successfully, this will also be conducive to the Eurosystem´s goal to guarantee stability for the whole euro area. Such a mutual improvement is desirable in a very broad sense: political stability, financial market stability, macroeconomic and - in the particular interest of the Eurosystem - price stability.

Already today, the euro is a key currency in Central and Eastern Europe. In most of the CEECs’ monetary policy strategies, exchange rates play a vital role and, wherever they are not a formal or informal intermediate target, they are at least a key monetary policy indicator. It is the euro upon which the CEECs’ currencies are oriented, or to which they are formally linked. Thus, EMU and the euro are already an anchor for stability for CEECs. Moreover, enlargement will thus extend the zone of stability in Europe, strengthen Europe’s international competitive position and will contribute substantially to prosperity, security and peace in the long term.

Integration of financial services markets in the EU

Beyond Monetary Union a huge amount of work has been undertaken in the EU to improve the functioning of the single market and the international financial system. By abolishing national boundaries and harmonizing different legislations, European integration has fostered the development of a single financial market in Europe. But the current regulatory and supervisory framework still strongly relies on national responsibilities.

The EU’s Brouwer Report found that there is a need to enhance arrangements for cross-border and cross-sectional co-operation, to improve the alignment of supervisory practices and to reinforce the collaboration between supervisory and central banking functions. The EU’s regulatory roadmap to integration is the Financial Services Action Plan. It contains more than 40 legislative and non-legislative measures. The deadline agreed by the European Council for implementing the entire Plan is 2005, with an earlier deadline of 2003 for the securities and risk capital markets. Moreover, considerable progress has been made in recent attempts to implement the Lamfalussy recommendations in the field of security market regulation. Consistent and efficient implementation of regulatory rules has been promoted by new institutional arrangements delegating rule-making powers to a committee or regulators whereas implementation at the national level is undertaken through a committee of supervisors.

These two examples illustrate that initiatives are under way and debate is ongoing. However, not all of the recommendations of the Brouwer Report have been implemented and many other issues still need further investigation and debate. But developments show that we are heading in the right direction.

The increasing integration of the European financial markets is only one further example that economic policy has become a subject of common interest in the European Union. It also requires putting financial stability in an EU-wide perspective alongside the still important national point of view. Accordingly, enhanced cooperation in the field of financial supervision, both nationally and between EMU Member States, can minimize the risks involved in deepening of financial market integration so that its indisputable advantages can take effect.

At the national level we have been observing various proposals to reorganize and restructure financial markets supervision. In Austria, the legal foundations as well as the practice of supervision have been evolving rapidly to respond to developments in the financial sector, to implement the EU financial sector directives, and to introduce ongoing improvements in international best practice. The most visible change in supervision and regulation has been the establishment of a single financial supervisory agency. Since April 1st, 2002, the Financial Market Authority performs banking, securities, insurance and pension fund supervision.

The Financial Market Authority is autonomous. It operates independently and is not bound by any instructions. The restructuring was aimed at establishing a high-quality, effective and at the same time cost-efficient supervisory regime.

Given the Oesterreichische Nationalbank's far-reaching operational integration in banking and financial market supervision, the Austrian central bank can fulfill its manifold macroprudential tasks also within the Eurosystem and can thus contribute to safeguarding financial stability.

The close involvement of central banks in the supervisory process has various advantages. It gives the central bank a much clearer picture of the economic reality that is behind the numbers visible in the books of banks. This information facilitates its role in safeguarding financial stability and creates a special advantage in spotting early warning indicators of financial crises and potential situations of economy-wide financial distress. Moreover, as a part of the Eurosystem central banks are integrated in an already functioning network of national and supranational institutions. Such a network is of decisive importance in the light of the structural change in European financial markets that already has taken place or is likely to come in the near future.

International financial system: transparency and crisis prevention

The integration of international financial markets is not a new phenomenon. What is unprecedented is the short-term nature, the high turnover and the many financial market agents. This evolution has been actively encouraged by public policymakers and academics, alike. In addition to an improved international allocation of capital, internationally integrated markets are thought to provide a welcome discipline to domestic policymakers.

The stability of financial market rests, in essence, on three pillars: institutions, market participants and infrastructure. A financial system is only as strong as its governing practices, financial soundness of its institutions, and efficiency of its market infrastructure. Installing and using sound governance practices is a shared responsibility of the market participants and the regulatory agencies. Indeed, recent experiences with systemic or significant financial sector crises have underlined the importance of good governance on the part of regulatory agencies. In nearly all financial crises of the past decade - Venezuela, Mexico, East Asia, Russia, Ecuador and Turkey - political interference in the regulatory and supervisory process, weak regulations, inefficient supervision and lack of public sector accountability and transparency, have been identified as contributing factors to the depth and size of the systemic crises.

Many of the major initiatives the international community had been taking, occured in reaction to financial crises in the 1990s. Based on this, policy-makers have been trying to become more forward-looking to avoid potential difficulties. In particular, three areas of concern have emerged:

First, many of the international fora are issuing internationally applicable "Core Principles" or "Standards of Best Practice". These should encourage improved practices in the economic and financial policies not only of emerging markets but industrial countries alike. Some noteworthy progress has been made in this area and many initiatives are emanating from the IMF.

The main vehicle for evaluating regulatory governance practices in the overall context of macroeconomic stability is the joint IMF-World Bank Financial Sector Assessment Program (FSAP). Aimed at identifying the risks, vulnerabilities, and development needs in the financial system, one of the main principles underlying the FSAP is that quality and efficacy of regulatory governance impacts on the overall governance practices within a financial system, and hence on its functioning and stability.

The FSAP provides an assessment framework that offers “peer review” of national financial systems, and a common platform for policy advice and technical assistance from the Bank and the Fund. The main instrument through which regulatory governance practices are assessed under the FSAP is through the assessment of the key international financial sector standards. Since the inception of the FSAP in 1999, public sector governance issues have been assessed in nearly 45 countries, through over 200 standards assessments. Given the positive impact FSAPs have made and the changes within Austrian supervisory structures with the establishment of the Financial Market Authority (FMA), the Austrian authorities decided to apply for such an assessment themselves.

Second, transparency on the part of all economic agents is deemed to improve the functioning of international markets and lead to greater financial stability. Much has been said, and, more importantly, achieved in the area of transparency in recent years. Indeed, there has been an explosion of codes and standards on different aspects of economic and financial policy. So much so, that some countries are claiming that the process needs to slow down. We should realize that standards and codes *cannot be universal* to a certain extent since some of them may not be appropriate for countries at a certain stage of development. Therefore, standards and codes should reflect different stages of development. The IMF’s initiative on Reports on the Observance of Standards and Codes (ROSCs) is a welcome step in this direction. I deem it critical that monitoring of the observance of standards and codes be fully integrated into IMF surveillance under Article IV.

Third, and most important is how to turn principles of good behavior into good practice. The international fora and institutions that I have mentioned do not have the power to enforce those principles. Only the IMF has some leverage in monitoring compliance given its legitimacy and the Article IV consultation process but has only real bite in program countries. Peer pressure, internationally accepted codes, and market discipline seem viable ways forward. Yet in the end, enforcement and compliance is still at the discretion of nation states.

International institutions and fora geared towards financial market stability

The institutional architecture of the current governance of global finance is both multilayered and dispersed. It involves complex networks of state, suprastate, substate, and private-sector actors. The challenge ahead is certainly to coordinate this network more efficiently. Let me give you a few examples.

The IMF due to its near universal membership of currently 184 countries is probably the only true international organization with legitimacy. Its mandate encompasses the promotion of macroeconomic stability and sustained noninflationary growth among its members. The Fund contributes to good governance through its policy advice, technical assistance, and program conditionality. It does so within its areas of expertise which covers the effective and transparent management of public resources, and the maintenance of a stable, economic, regulatory and legal environment.The Fund took a leading role in the management of the Third World debt crisis in the 1980s and the emerging market financial crises of the 1990s. Since 1996 the IMF has promoted data standards - the SDDS - that aim to make information on and for financial markets more reliable and accessible. Recently the Fund’s International Monetary and Financial Committee (IMFC) has served as an important forum for intergovernmental consultations regarding the international financial architecture, drawing upon discussions in the FSF and the G20. At present, the IMFC is for example engaged in drawing up the fundaments for a sovereign debt restructuring mechanism (SDRM) which should allow for a better resolution of external sovereign debt crises.

Central bank governors of the Group of Ten (G10) advanced industrial countries have met regularly at Basle at the BIS since 1962 to discuss monetary and financial matters of mutual concern. Unfortunately Austria is not a direct member of this group, but we surely have profited from their initiatives.

Most important for international financial governance has been the Group of Seven (G7) summits, held annually since 1975. From time to time, G7 leaders have given orientation for important policy initiatives.

The G10 and the G7 have from time to time set up working parties to explore specific issues related to global finance. The best-known example is the Basle Committee on Banking Supervision (BCBS), formed as a standing group of the G10 in 1975. Most significantly, the BCBS has formulated the Basle Capital Accord, a framework first issued in 1988 for assessing the capital position of international banks, which is now under revision (Basle II), and Core Principles for Effective Banking Supervision, published in 1997.

On a more specific problem, the G7 created the Financial Action Task Force (FATF) in 1989 to combat drug-related money laundering and more recently has been involved in the combat against the financing of terrorism. After the Asian and Russian financial crises, the G7 promoted the establishment of the Financial Stability Forum (FSF), which first convened in April 1999. The forum's mandate was an important step towards better identification of vulnerabilities that affect the international financial system and for improvement of coordination and information exchange among the big authorities responsible for financial stability.

While we greatly welcome the work of this important committee, we are not completely satisfied with the trend of moving important discussions out of the main International Financial Institutions, where all countries are represented, into special fora with a selective membership.

Private sector initiatives

The financial sector presents an outstanding example of another major trend in contemporary governance, namely, the turn to nonofficial mechanisms of regulation. A number of national securities and exchange commissions have lain in the private sector for some time, of course, and IOSCO also includes over fifty securities exchanges and dealers associations as Affiliate Members. Meanwhile several industry associations have promoted the international harmonization of standards and devised a number of self-regulatory instruments for bond and equity business in global financial markets.

These bodies include the International Council of Securities Associations (ICSA), the International Federation of Stock Exchanges (FIBV), the International Primary Market Association (IPMA), and the International Securities Market Association (ISMA). The ISMA indeed describes its task as 'regulation by the market, for the market'. In addition, private bond-rating agencies like Moody's Investors Service and Standard & Poor's - and the financial markets whose sentiments they reflect - have come to exercise considerable disciplining authority over many national governments.

Private industry plays an important role as a disciplining device in the specific area of conduct of business in securities markets. This is probably due to the ability shown by the securities industry, until recently, to discipline itself effectively and in line with public objectives. However, this ability is being put into question by the increasing complexity of financial markets and instruments, as the Enron case shows. Indeed, a tendency to reinforce *public* authorities' vis-à-vis self-regulatory organisations can be observed in Anglo-Saxon countries, in response to this concern.

Private-sector inputs to the governance of global finance also figure outside the securities area.

For example, nongovernmental groups like the Group of Thirty or the Derivatives Policy Group have taken a lead in developing rules for derivatives markets. Two other private-sector bodies, the International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC), have devised the main accountancy and auditing norms currently in use for global business. However, this past year has brought widespread questioning of the quality and integrity of the information available to markets - and the behavior of some corporate executives.

Both the private as well as the public sector have a stake in the healthy functioning of financial markets. Therefore, we have to foster a new public/private partnership in the governance of financial markets. Moreover, we also need international public partnerships to avoid arbitrage of 'standards'.

Conclusion

First, standard-setters have, by-and-large, passed the initial stage of establishing continuity and have created mutual recognition and trust among their members. There are, however, clear differences in the level of ambition across the standard-setters.

Second, whenever market forces fail to remove relevant obstacles to integration, public authorities have to intervene either to remove the obstacles, or to act as a catalyst to complete the integration process. Moreover, they have to act to provide genuine public goods. Hence, public agents need to have a broad view of the necessary policies in support of integration, focus not just on lifting the remaining regulatory obstacles, but also on the cooperative arrangements among private agents and maintaining effective competition to the benefit of market participants.

Third, the achievement of a public good can refer to the national jurisdiction of the public authorities, while the overall global optimum may not be achieved. Thus, national authorities have to take into account the externalities of their actions on an international level.

Fourth, the euro and the European integration process have greatly enhanced our capacity to absorb shocks and to react quickly in situations of financial turmoil. There are still tasks and room for improvement ahead us, but we have done a lot in recent years to constantly optimize our financial infrastructure. On this way, we have kept our own European style and still have worked successfully on gaining a strong voice in international fora, which are proliferating all around in the process of constant buildup of an international financial governance system.

A great deal of progress has already been made in strengthening the central pillars of the international financial system: institutions, markets and infrastructure. What is also clear is that further progress remains to be made in *implementing* internationally many practices already recognized as being desirable. Many years of effort, both at the domestic and at international levels, will be required on the part of central bankers as well as many others to ensure that the international financial system demonstrates the proper balance between efficiency and stability.