Jean-Pierre Roth: The role of the International Monetary Fund in promoting financial stability - a Swiss perspective

Speech by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank, at a meeting with directors of the most important Swiss firms in Argentina, Buenos Aires, 16 November 2004.

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1. Introduction

I am delighted to be here in Buenos Aires to address such a distinguished audience, and I thank Ambassador von Muralt for organizing this event. For the next 20 minutes or so I would like to speak about the International Monetary Fund's role in promoting international financial stability, and this from a Swiss perspective.

I know that talking about IMF policy can be difficult here in Argentina. However, the Argentine case should not hamper our discussions. It should invite us to reflect on what the Fund has achieved so far in promoting international financial stability and what its present challenges are.

Promoting and safeguarding international financial stability was part of the mandate of the IMF in 1944, when the institution was established. It is still, in my mind, the core mandate of the IMF today. There should be no doubt that a strong and resilient international financial system is crucial for global growth and prosperity. This is even more so the case after the structural changes of the last decade, in particular the worldwide information technology revolution that led to a strong increase in the size and sophistication of international capital markets. In a globalized world, it is even more imperative for the Fund to focus on promoting stability as a global public commodity. We have enough experience to know how costly it can be if things go wrong.

Saying that Switzerland treasures a stable international environment is in many respects an understatement. Given the openness of our economy and the fact that we host an important financial centre, international financial stability for us has all the connotations of a vital national interest. To put things into the right perspective, allow me to mention a few figures that show how interconnected our economic well-being is with global developments. In 2003, Swiss exports of goods and services amounted to 44 percent of GDP. The GDP contribution of our heavily internationally oriented financial sector reached 10 percent. This figure rises to 14 percent if we also include the insurance sector. Swiss banks occupy a leading international position, particularly in the area of wealth management. The value of total assets managed in domestic banks as at the end of 2003 amounted to US$ 2.7 trillion. According to various estimates, this corresponds to about one-third of the world's total private wealth managed abroad. Last, but not least, the banking and the insurance sectors combined employ approximately 185,000 people, the equivalent of 6 percent of total Swiss employment, whereas the fiscal contribution of the banking sector alone amounts to about 13 percent of total tax revenues.

Under the circumstances, it should come as no surprise that Switzerland fully supports the IMF in attaching the highest priority to stability and crisis prevention. The main tool in this endeavour is clearly surveillance. Surveillance remains the most important activity of the Fund as its first line of defense against turmoil. However, this activity is hardly known to the wider public. Unlike an agreement on a multi-billion rescue package, efforts to prevent a financial crisis never hit the headlines. Surveillance is relatively unknown, probably also because it is a very complex animal, hard to explain, and with dozens of connotations.

I have neither the time nor the desire to elaborate on all the elements of present-day Fund surveillance. However I believe that some points are worth emphasizing. In the first part of my presentation I shall begin with some remarks on transparency, both in the context of the Fund and with regard to its role in promoting market discipline. I shall then elaborate a bit on surveillance in financial markets. In the second part of my presentation, I shall take up issues linked to crisis resolution. However, much effort goes into crisis prevention, crises cannot be completely ruled out in an open and dynamic global economy; the IMF, therefore, needs to be and to remain an efficient "fire-fighter". I shall elaborate on this "fire fighter" role of the Fund, on the limits of its action, and on what is necessary to preserve efficiency and credibility in this context.

2. Surveillance and crisis prevention

Let first me turn to crisis prevention. I shall start with a general remark. Surveillance is the backbone of crisis prevention. However, for surveillance to be effective, it must not only be correct, it must also be implemented. Implementing stability-oriented policies and efficiently monitoring domestic markets and institutions is the primary responsibility of the member country. The Fund can only help countries that are willing to help themselves. As any Argentinean would say, it takes two to tango. The Fund's role is limited to providing the best possible objective advice built upon the best possible analytical expertise.

This is not to say, of course, that Fund advice is always correct or appropriate. Though Fund staff is highly qualified, it can make mistakes. Indeed, mistakes have been made most often due to a poor understanding of the country-specific circumstances.

It is therefore crucial to maintain a high-quality dialogue between authorities and staff at all times. The more the interaction between a country and the Fund is frank, constructive and based on mutual trust, the bigger the chances are of a valuable and usable outcome. Though Switzerland joined the IMF in 1992 only, we can already record some very good experiences in this regard. Most appreciated, for instance, were the discussions that took place between our experts at the Swiss National Bank and Fund staff in the period of the formulation of the new monetary concept that was introduced in 2000.

The second point I want to raise is that if mistakes cannot be avoided, at least we should learn from them. It is the sovereign prerogative of any state to deal with that issue within its own borders, and I shall not elaborate on that. The Fund, on the other hand, is an international public institution and is constantly confronted with the need to justify its actions. Though strictly speaking it remains accountable only to its members' authorities, in reality, the legitimacy bar has been raised in recent years. A wider section of society is more and more eager to engage the Fund in the various aspects of its activity. I think this is a most welcome development: the Fund has become an institution much more ready to listen than before. A milestone in this respect has been the institutionalization of the process of evaluating Fund activity with the creation of an Independent Evaluation Office in 2001. This office is now fully operational. It has already produced very valuable analyses, and I am sure that its evaluations will greatly contribute to improving the future way of doing business of the Fund.

The prerequisite for a constructive enlarged debate is of course transparency. And transparency has taken a "quantum leap" in the last decade, to use the words of the Managing Director Rodrigo de Rato. Switzerland has always pushed to help the IMF in opening up and overcoming its questionable reputation of being a secretive institution. We are happy with the results. The transformation from an institution that used to publish virtually nothing to an institution that publishes virtually everything took place in a very short period of time. We like to believe that our influence in this policy change was not negligible, not least with our unilateral decision in 1994 to publish the Fund report of the first Swiss Article IV consultation against all the then-existing rules. This was a precursory move that, although it earned our executive director a few moments of severe and formal reproof from the Board, had the merit to de-dramatize the publication debate by showing that the world would not come to an end if more information was disseminated about national policies. Subsequent developments have proved that much more could be done without jeopardizing the fine trade-off between openness and maintaining the Fund's role as a confidential advisor to its members.

Transparency is important not only for legitimacy reasons. In the new information-technology world, it has become a crucial element of stability. Transparency, together with more reliable information, facilitates a smoother functioning of markets and helps them in assessing risks more accurately, thereby strengthening market discipline. Stronger market discipline through transparency must be the new rule. Globalisation forces us to change. This means, for instance, that the range of action has considerably shrunk for those countries - rich or poor - that are active on financial markets. Structural and balance sheet weaknesses, inappropriate exchange rate regimes as well as inconsistent macroeconomic policies must be addressed openly, and without hesitation or delay, to avoid market reaction. In some cases, a loss of confidence may fuel a snowballing effect that can easily lead to full-blown capital account crises with high economic and social costs and serious risks of a contagion.

By changing the rules, globalization forced the international community to change the framework of surveillance itself. This came under the general heading of reforming the architecture of the financial system. It is an ongoing, very ambitious project with many ramifications. Switzerland strongly supports it as well as all the related initiatives. I think we can safely say that a lot has already been achieved. The structure of the international financial system is today more robust and in a better position to withstand future challenges. Part of this project was to provide more information about countries and their policies to help investors make the right judgments. A number of standards and codes were defined to include data dissemination, fiscal transparency, and monetary and financial policy transparency. Another aspect of the reform was strengthening Fund surveillance through its renewed focus on financial markets. Much more attention is today paid to the structure of national financial systems and the institutional preconditions that have to be in place for countries to fully benefit from capital account liberalization. A key initiative in this regard is the Financial Sector Assessment Program (FSAP), a health check-up of national financial sectors made in collaboration with the World Bank. Switzerland volunteered to undergo such a check-up in 2002. Once more, it was a useful and gratifying experience to interact with outside experts. And the reason I am saying this has nothing to do with the fact that the Swiss financial center came out of this surveillance exercise with very high marks.

3. Financial crisis resolution

Let me now turn to the second part of my presentation, the Fund's role in crisis resolution. Here I have no direct Swiss experience to report on since my country, fortunately, never had to resort to financial support from the Fund. I will therefore speak from the perspective of a medium-size shareholder that believes that financial crises are market failures with potential systemic risks and that the Fund can and should play an important role in resolving them.

The nature, scale and spread of financial crises have changed dramatically since the Tequila turmoil in Mexico in 1994. Financial integration and capital account liberalization brought about a huge increase in financial flows. Emerging economies did benefit from this new reallocation of international savings and some staggering economic results were obtained (annual GDP growth between 1986 and 1996 for countries in South-East Asia averaged close to 8 percent). However, the new financial setting also made emerging countries particularly vulnerable to sudden changes in market sentiment. Losses in investors' confidence could erupt much more quickly and spread across markets in a matter of days. Unfortunately, the economic and social costs of the new crises also increased substantially.

I think we can safely say that the Fund, like anybody else, was caught by surprise by the virulence of the turmoil that hit Asia in the 90s. When Thailand and even more so Korea were on the verge of financial collapse the Fund looked very much like those generals always ready to fight the previous war. Not even its financial means were adequate, and governors were rushed to decide a speedy 45 percent increase in quotas in January 1998 to supplement the rapidly depleting Fund resources. It didn't take the Fund long, however, to react, to pick up the challenge and, all things considered, to come out of that difficult situation relatively unscathed. No-one should claim that everything went smoothly, though, or that no mistake has ever been made. From the side of the Fund, too, it was a particularly bumpy trial and error process.

Quickly restoring market confidence became the name of the game. How? This is the difficult question. I shall not elaborate on the design of the various programs over that period. A very extensive, at times quite critical, economic literature on this matter, with pieces signed by the best pens in the profession, is readily available for those of you interested in more details. What I shall retain from that experience is that the key to the Fund's results were its willingness and ability to react flexibly to the various circumstances, its readiness to recognize mistakes and change the course of action when necessary, and all this while sitting on a ticking time bomb.

This flexibility bids well also for the future. The importance of adaptability in tackling future financial turmoil can never be sufficiently stressed. In a rapidly changing world, any silver bullet can soon lose its shine. No piece of advice is sure to preserve its value over time. What we must ensure, more than defining a set of measures written in stone, is preserving the capacity of the institution to quickly generate appropriate new responses to handle new situations.

Financial support is the second aspect of the Fund's role in crisis resolution. With the emergence of the new capital account crises, the need for Fund resources has sharply increased. The access limits to Fund resources that were conceived to tackle the more traditional "current account crises" became obsolete overnight. The decision-making process tilted completely from rules toward discretion. Multi-billion packages not only became common place; over the years, the burden of financing was increasingly put on the IMF. In many respects the situation became unsatisfactory.

One can easily understand that setting strict limits to Fund financing may not be appropriate in capital account crises, as it may restrict the institution's room for maneuver too severely. The Fund's business is to take calculated risks, and in the new environment of integrated markets, there are cases where heavy financing of a country's balance of payments difficulties is justified. In Korea, for instance, it was a success. The 50billion dollar rescue package supported a rapid turnaround in confidence and economic performance. This being said, however, one point should be very clear. The IMF is not, and should not be, in a position to always fully offset the volume of private flows. For one thing, Fund resources are limited. For another, the systematic relief of debtors' and private creditors' responsibilities through Fund financing would create problems of moral hazard. An excessive bail-out of negligent investors would also be perceived as unfair by those who are left behind to bear the cost of the crisis.

The most important aspect in decisions on exceptional access to Fund resources does not concern amounts. It is rather an issue of whether lending is justified altogether. To help to take this decision - and also to increase the predictability of Fund action - a framework was developed. According to this framework, the Fund should grant exceptional access if three basic conditions are fulfilled. First, there must be a high probability that the debt will remain sustainable; second, the country must have good prospects of regaining access to private capital markets; and third, the policy program of the member country must provide a reasonably strong probability of success. This must include not only the member's adjustment plans, but also its institutional and political capacity to deliver this adjustment. This also means that the cooperation between authorities and the Fund must be good and capable of generating constructive team-work.

It has been easier to define this framework than to implement it. To some extent, this is not surprising, as one cannot avoid that a strong element of judgment will influence the assessment of the three above-mentioned conditions. And when there is room for judgment, there is always room for political interference. Moreover, if we add the fact that the alternative to large financing very often is the prospect of a full-blown crisis, with unpredictable but certainly high - and possibly systemic costs - it is not difficult to understand why the international community has often condoned sub-optimal decisions. One way to improve the situation and to eliminate this decision bias towards excessive Fund financing would be to find ways to involve more consistently the private sector in the resolution of crises and thereby in burden sharing. Once again, this is easier said than done. Progress in this respect has been disappointingly slow to emerge.

Should we conclude that it is too difficult for the IMF to say no? I would definitely not go that far. While recognizing that capital crisis decisions may be too important to leave only to experts, bending the rules too often can also have serious consequences. One consequence is that the credibility of the institution will eventually suffer, and this will negatively affect its efficiency to the detriment of the membership as a whole. The second is that by granting too many resources under too uncertain conditions the financial soundness of the IMF will be jeopardized. The financial soundness of the Fund may well constitute in itself the topic of another speech. Let me just tell you that, although the IMF financial situation remains strong, recent developments in markets and in Fund lending have increased the risks for the institution.

Shareholders of the Fund, through the Executive Board, have the responsibility that the Fund takes sensible decisions. They have an equally important responsibility to safeguard the credibility and soundness of the institution. This can best be done by ensuring that, to the extent possible, the game is played according to the rules. To best pursue its mandates, the Fund must not only be competent and financially sound, it must also be able to preserve its own independent judgment. With this caveat, I would have no problem sharing the very widespread belief that if the Fund did not exist, we would have to invent it.