Turalay Kenç: Stocktaking of international financial architecture

Remarks by Mr Turalay Kenç, Deputy Governor of the Central Bank of the Republic of Turkey, at the "Stocktaking of International Financial Architecture" Conference, organized by the Reinventing Bretton Woods Committee (RBWC), Shanghai Development Research Foundation (SDRF), Research Institute for Banking and Finance, China (PBOC) and Korea Institute for International Economic Policy (KIEP), Shanghai, 26 February 2016.

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Over the last two decades the world has witnessed substantial increases in the trade volume to global GDP ratio, sharply grown international investment positions and significantly deepened production supply chains in the most part of the globe. As a result, monetary and financial policies across countries have become much more correlated. The conference organizers rightly asked the most crucial question whether the international monetary system (IMS) is still sufficiently stable in this current environment with a growing interconnectedness.

In addition to this heightened interconnectedness, the global economy and financial markets face the challenges of the unconventional and unusual monetary policies in the advanced economies as well as diverging monetary policies of these countries, uncertainty in commodity prices, the risk of China's economic hard-landing and the unintended market liquidity consequences of the recent financial sector reforms across the world.

Large asset purchasing programs of the major central banks have depressed global bond markets with decreasing long-term yields as well as short-term yields and their negative nominal policy rates further destabilized bond markets and in general financial markets. Heightened volatility in global financial markets can be associated with the presence of very low and even negative rates rather than the underlying macroeconomic and external imbalances. In these circumstances, any change in interest rate differential across countries is likely to create greater impacts than otherwise. If this interest rate change takes place in the largest and the most significant economy in the world, then the impact will expectedly be further magnified.

The Fed's start of interest rate normalization has demonstrated that its impact on the global economy and financial markets indeed has been large, giving rise to significant capital outflows from emerging market (EM) economies, large adjustments and volatility in exchange rates as well as widened EM spreads and interest rates. The adverse effects of the Fed's interest rate normalization has been on average larger than those occurred in previous two financial turmoil episodes, namely the Eurozone sovereign debt crisis and the US tapering tantrum. However, the disparity between the effected countries has been large too. The plummeted commodity prices as well as other factors led to this outcome as commodity exporters suffered from both the lower commodity revenues and the tightening global financial conditions. Financial markets also differentiated EM countries by policy frameworks and prudent policies. Those having rich and better policy frameworks and prudent policies have withstood the recent global financial turmoil better than the others.

With lessons learned from previous episodes and improvements over the years, emerging market economies on average are better positioned to withstand financial turbulences, both now and in the future, than in the past. They embarked on extensive structural reforms aimed at overhauling financial regulatory and supervisory systems, strengthening public finances and fiscal discipline, granting central banks independence and adopting flexible exchange rate systems. These reforms enabled them to implement more prudent and countercyclical policies. EM economies supported their post crisis reforms by accumulating adequate foreign exchange reserves as an alternative to the IMF provided financing, which carries strong conditionality, as well as by further deepening and broadening their domestic financial markets. As a result, stock and flow balances, policy frameworks, and levels of economic confidence and market development in EM economies have strengthened substantially and radically. Deepened and

broadened domestic financial markets have alleviated the so called original sin problem. It is fair to say that they now look strong enough to render the adverse effects of external financial shocks manageable. Given the current IMS what EM economies can most rely on are their prudent policies, better policy frameworks, foreign exchange reserves and flexible exchange rates.

As for the IMS related questions of the session namely

- "Do floating exchange rates along with largely unrestricted capital flows play their role of shock absorber? Are we going to witness a return of currency crises of the 1990's?
- What does China economic slowdown and its current adjustment means for capital markets and for the quest of renminbi internationalization?
- Should and can the systematically important countries "internalize" their spillovers effects to mitigate negative external impacts?"

I organize my points around the three functions of an IMS – liquidity, confidence and adjustment.

On liquidity function, there are two areas that we require significant improvement on the current IMS. The first is related to excessive liquidity during normal times. What are the appropriate policies to curb excessive capital flows? The IMF's approach advocates that recipient countries should implement the capital flow management measures and use macro-prudential tools. Hence, there is an asymmetric treatment of countries as source countries are not expected to do much if not at all. There is of course room for a symmetric treatment. The Holy Grail may exist in the IMF's articles of agreement as it states in Section 1 that "*each member shall seek to promote stability… by fostering a monetary system that does not tend to produce erratic disruptions*".

The second is about the existence of safety nets providing liquidity during financial stress times.

Again, the optimal provision of liquidity is the main issue. To what extent it should be divided among global, regional and local sources. It is a classic efficiency versus moral hazard problem. Changes in governance structure of the global safety net providing IOs have a potential to alleviate this problem. The 2010 IMF quota and governance reforms are a significant development as they give greater voice to EM countries on governing the IMF policies and procedures. This development together with increasing awareness of sufficient global safety nets would strengthen IMF recourses and reduce their stigma effect. Again, there is a symmetry issue in the provision of liquidity during financial stress times – whether there should be internationally designed mechanisms enforcing countries that supplied excessive liquidity in the first place also to provide liquidity to all recipient countries during financial stress times such as through currency swap arrangements.

The confidence function of the IMS highlights the fact that all stakeholders including financial markets have greatest confidence in the functioning, resources and governance of the system. Strengthening its recourses, improving its governance and advancing its functions will crucially bolster all stakeholders' confidence in the system. What have been done recently along the lines of the 2010 IMF quota and governance reform, the inclusion of the renminbi in the SDR system and the recent increases in the IMF resources greatly improved confidence in the IMS.

The adjustment mechanism of an IMS is mostly related to its sustainability but also affects its confidence function. The IMS requires a symmetric and fair adjustment mechanism. The G20 plays a central role in the adjustment mechanism of the IMS through fostering international policy coordination and cooperation. The IOs, especially the IMF, largely execute this G20 objective through bilateral surveillance and multilateral surveillance or oversight of the world economy. Since the global financial crisis (GFC) giant steps have been taken at the G20 to strengthen international policy coordination and cooperation. Overall there are two opposing

developments affecting the IMS. On the one hand, the significant reforms since the GFC have strengthened the IMS. But on the other hand, growing interconnectedness especially through increased international investment positions together with unconventional monetary policies pose challenges to the IMS.

In these global circumstances, having faced the deterioration in inflation and its outlook reflecting the pass-through from the TL depreciation and domestic factors and elevated volatility in capital flows together with tightening global financial conditions the Central Bank of Turkey has been following a tight monetary policy to fight inflation, taking liquidity stabilizing measures for the foreign currency market and ensuring the stability of the financial system.

This policy framework was announced as a “road map” document back in August 2015 outlining monetary policy, foreign currency liquidity and financial stability related measures and aimed at alleviating policy tradeoffs.

The key idea is to provide market making facilities to the local banks when they face financial stresses in the global markets. They are then allowed to borrow in foreign currencies from the central bank and use their all liquid assets irrespective of their denominations i.e., local currency and foreign currency denominated assets as collateral when they borrow from the central bank in any currency.