Mr. Tietmeyer discusses the role of the IMF in the global economy Opening address by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, at the symposium "The Role of the IMF in the Global Economy" held in Frankfurt am Main on 2/7/98.

A mass of analyses, commentaries and proposals have already appeared concerning the crisis in some emerging markets and the problems in certain countries in transition. Many have helped to enlighten us, but some have merely created more confusion. I hope that today's symposium will belong in the enlightening category.

The title of the symposium sums up the main issue: we are living more and more in a global economy. This has been caused by two driving forces; firstly, political factors: the opening of goods and services markets worldwide, which has been gradually proceeding for decades the ever-growing liberalisation of capital transactions, and the internal orientation of countries in transition to market-based structures. Secondly, technical developments are having an ever-increasing impact: the almost perfect information technologies now available, and the highly efficient transportation systems.

These two aspects are interlinked and mutually reinforcing. The political opening strengthens the economic incentives to seek newer and better technical solutions. Conversely, technical progress creates powerful pressures to liberalise markets as it makes the maintenance of barriers more and more inefficient and expensive.

The benefits and challenges of globalisation are inextricably linked. Above all, globalisation brings major benefits for everyone. The most important benefits are: greater efficiency through stronger competition, a better allocation of resources and, consequently, falling costs. Ultimately, the rising standard of living worldwide owes much to the gains produced by globalisation.

But it has other noticeable effects, too. Globalisation demands considerable internal flexibility from economies, and, at the same time, credibility from the national political decision makers. And the integration of previously national markets increases interdependency. As a result, national and regional crises can no longer be considered in isolation. Contagion is a constant danger in the world of today and tomorrow.

That is why, in addition to each country's primary duty to prepare for and prevent financial crises in its own territory, joint efforts at the global level are also meaningful and necessary. And this is without question the task of the IMF.

Some people believe that the recent financial crises would not have happened if there had been no globalisation and that, consequently, the gradual opening of markets is the main cause of the problems. But that view is too short-sighted. The main causes are the misguided or at least risky policies pursued by the countries in question. Essentially that also applies to the countries affected indirectly. Their own internal weaknesses make them vulnerable.

It is also true that the global financial markets, with their tendency towards short-termism, are sometimes a factor in making the magnitude of the potential reversal so great. If a country then loses the confidence of investors because of a political error, it is punished hard - sometimes too hard, at least for a time.

II

The outbreak of the crisis in some Asian countries poses some new questions because some of the key fundamentals were quite sound: In many cases the public fiscal balance was in surplus or at least was not in excessive deficit. Unemployment was fairly limited. The monetary policy stance was mostly quite restrained, and inflation remained moderate for a long time. For quite a while current account deficits were financed by capital imports apparently unproblematically.

Some indicators even showed an exceptionally positive trend. In particular, the saving and investment ratios were comparatively high, and real growth in this region was stronger than elsewhere. Until a short time ago, the title of such a symposium might well have been “The Asian economic miracle”.

On closer inspection, however, it can be seen that the economic successes of recent years already carried the seeds of the later crisis: massive short-term capital inflows, asset inflation in the equity and property markets, in some cases a misallocation of capital, currency appreciation in real terms, decreasing competitiveness and growing current account deficits. These symptoms also pointed to internal weaknesses and political mistakes: for example, an over-rigid pegging of the exchange rate to the dollar and inadequate efficiency of the domestic financial sector.

Certainly, there are good reasons for pegging an exchange rate to another currency. Credible pegging to a stable anchor can help to reinforce internal discipline. And it can help to lower the risk premium demanded by investors.

But there are other considerations which can become a danger if the exchange rate is pegged too rigidly: They can make it hard to pursue the objective of internal monetary stability. Interest rate policy becomes a hostage to the exchange rate, for - given strong capital inflows - an interest rate rise often has an opposite impact on monetary expansion than the one intended. A persistent stability gap can then arise in comparison with the anchor country which over time can endanger the competitiveness of exports. In addition, the fixed exchange rate encourages residents to borrow in foreign currency at relatively favourable nominal interest rates. However, they expose themselves to substantial risks if their own currency has to devalue.

In this way the policy of rigid exchange rate pegging helped to make some countries vulnerable to a change in mood in the markets and hence to a rapid reversal of financial capital flows.

Moreover, in some cases the domestic financial sector was underdeveloped and not very efficient. Not infrequently the financial institutions were subject to political pressure. And the supervision was not particularly effective.

When the capital began to flow back out of these countries, this soon led, in conjunction with a vulnerable financial sector, to a massive disruption of the economic system. Hence mistakes in monetary policy, omissions in supervising financial institutions and insufficient domestic competitive structures in some cases made the crises possible in the first place and were largely responsible for the scale of the crises.

A number of Asian countries tolerated the emergence of a bubble economy and evidently did not correctly assess the associated dangers. However, the financial and foreign exchange markets cannot move out of step with real economic conditions in the long run. A reversal will occur one day - suddenly and mostly in an exaggerated form. That is dangerous for the countries concerned, but also quite often for others, too.

An overall analysis of the problem must include some further aspects:

Firstly, the crisis has not yet been overcome, despite the IMF’s intervention and despite the reforms initiated in a number of countries. The causes - but also the resistance to solutions - are often deep-seated. It is very hard to change long-established patterns of behaviour and accustomed routines. Yet policy makers in the countries concerned cannot and should not shy away from these challenges - in the self-interest of the countries concerned but also in the interest of others.

It is encouraging that certain countries have taken important steps to tackle these challenges and are reaping the first rewards. That also confirms that the IMF has pointed these countries in the right direction.

And secondly, some structural problems of the Asian emerging economies are by no means unique. Such problems also exist elsewhere, and often have similar causes: in some countries in transition the financial sectors are too weak; external debt is often rather short-term and denominated in foreign currency to an excessive extent.

In some industrial countries there are at the moment tendencies towards exaggerated asset prices. One must ask oneself whether the prices reflect the true value of the underlying assets and whether perhaps the potential for a reversal is becoming too great.

The situation in Japan is a special problem. The efforts to overcome the difficulties in that country via monetary and fiscal policy means have been unsuccessful so far. But it is not exclusively a problem of finding the right macroeconomic course.

It would seem that there is still too little competition on the goods and especially the financial markets in Japan. In particular, the problems in the financial sector, which have accumulated over years, demand convincing, forward-looking solutions. At the same time a problematic vacuum exists in some areas and the political response has been too hesitant and vague with respect to the necessary corrections. It is to be hoped that the new announcements will soon be followed by convincing and confidence-building actions.

III

In dealing with financial crises, the Fund has learned many lessons in the past few years and has accumulated important experience with the strategy of intervening very early with massive amounts. The rationale behind this strategy is more or less as follows: the best way to counter a crisis of confidence in a country, once it has broken out, is to take resolute action to provide comprehensive conditioned financial assistance and so to set an unmistakable signal. In my view, however, the results of this strategy have not been particularly encouraging in a number of cases.

At least three serious drawbacks are apparent: Firstly, the frequent application of this strategy is simply very expensive for the Fund.

Secondly, levels of financial assistance that are announced very early on act like a kind of benchmark. And in the next crisis they are considered the absolute minimum. If the international community were to offer less, the countries concerned and the financial markets could well interpret this as indifference, as proof of a kind of benign neglect - or even malign neglect.

And thirdly, an early, massive intervention by the IMF undermines the ability of the financial markets to function in the long run. Functioning markets need not only the chance to make profits but also the possibility to punish mistakes through incurring losses. Otherwise there is a danger of a moral hazard. And not only for the policy makers of the countries concerned. The markets, too, will end up underestimating the risks because they are confident of a bail-out. This leads to global misallocation of capital and shifts costs on to the public sector.

Basically, this reveals the central problem of any form of interventionist economic policy: the other players come to expect interventions and anticipate the later measures. On balance, it has become clear that an interventionist strategy for managing financial crises can easily lead to a dead end.

IV

So how can the IMF escape from this dead end on a lasting basis? Naturally, there is no magic formula. But there are a few general conclusions.

The first requirement is that the Fund should concentrate less on correcting a market outcome that has already occurred. Instead it should try to influence the *ex ante* setting in which the financial markets operate and to improve their functioning.

That begins with improved prevention. Above all, this requires more transparency and information so that the financial markets can form their expectations more rationally and more realistically and so that the IMF itself can assess the need for action more quickly. Specifically, this means publishing more data (especially on the maturity structure and denomination of external debt), publishing timelier data and at shorter intervals (if possible, monthly instead of twice-yearly) and using more sources, that is not only the data of the borrowers themselves but also data from the lending financial institutions in the industrial countries.

Improving the data quality of a number of countries will certainly require a substantial intensification of basic statistical work and more openness. However, the return of benefits is likely to be considerable.

The advantages of greater transparency are obvious. The countries concerned have a greater recognition of the need to take certain action. The “ownership” of adjustment programmes, in particular, increases. And there are less uncertainties for the market players.

The limits of such transparency must lie where confidentiality and the “internal openness” of advisory or decision-making processes have to be upheld. But in the integrated world of today it must also be clear that national sovereignty is increasingly coming up against its limits.

The IMF itself can contribute towards more information. But it is not a rating agency. The ultimate responsibility for correctly assessing chances and risks in a given country remains with the players in the financial markets.

In the broader sense, greater prevention also includes technical support. For example, the international community can and should provide support, especially in the field of banking supervision, where a number of emerging economies evidently still have some weaknesses. The BIS recently set up the Institute for Financial Stability in order to train expert staff, and the committees of the G-10 central bank governors, which mostly meet in Basle, have now intensified their cooperation with the representatives of the emerging economies.

In addition, the IMF should take account of the recent experience and specific conditions of countries when making its policy recommendations. For example, the level of development of the domestic financial sector needs to be taken into account in assessing the right route to the liberalisation of capital transactions. And when recommending an exchange rate peg, the country’s ability to cope with such a regime needs to be considered carefully.

Finally, one aspect of prevention should surely be that the IMF, wherever economic policy weaknesses are apparent, should exert greater pressure if necessary on the government concerned before a crisis has broken out, even if the extent to which this can be done publicly is a very sensitive question.

For the main contribution towards effective crisis prevention must be made, of course, by the countries concerned themselves. That applies to emerging economies and countries in transition, to the poorer developing countries and, not least, to the industrial nations as well.

A necessary precondition for winning the confidence of the markets is convincing economic and political action (good governance). No one can ignore market mechanisms in the long run without causing economic damage. And political power must not be misused in order to secure personal advantages and to distort the domestic economy with lucrative monopolies.

V

When a crisis does break out, the IMF should again pay more attention to its catalyst role as a moderator and coordinator. The primary aim must be to maintain or restore the crisis countries' access to <u>private</u> capital.

Therefore the IMF should contribute towards bringing creditors and debtors together round the table at an early stage and towards working out market-based solutions. I fully agree with what Mr. Michel Camdessus said in a recent interview in a German newspaper: "Moral hazard exists. Overcoming this problem, however, requires the involvement of the private creditors. Their participation is the backbone of our activity".

Clearly, not every case is identical. It is naturally easier to perform the role of moderator if - as in some Asian cases - the creditors are in the main commercial banks. In some cases in Asia the IMF seems to have been rather late in seizing that chance. If the groups of creditors - as in the Mexico case - are more widely spread and heterogeneous, it may be more difficult to bring all the interested parties together around one table. On the other hand, if non-banks are involved more heavily, the dangers of a spreading financial crisis in the sense of a systemic risk also tend to be smaller.

The IMF should also minimise its provision of financial assistance not least because these are <u>public</u> resources which it is distributing. It should therefore itself bear only the absolutely necessary portion of a financing package. It can define a maturity and an interest rate for the resources which it provides that give the debtor an incentive to repay them as soon as possible. Finally, of course, the IMF must make its help subject to certain requirements, that is it must define the conditionality. That is part of the IMF's mandate and is also in the interest of the world community.

In defining the conditionality it is imperative to tackle the underlying causes. Time after time it has become clear that macroeconomic measures alone often do not suffice. In Asia - as elsewhere - it has become apparent instead that one of the root causes was the insufficient soundness and robustness of the financial sector.

The work of the committees in Basle and the efforts of the Fund have laid the basis for appropriate rules and appropriate supervision. The key need now is to translate that into action. For many of the countries concerned that may not be easy. But the gains will make the effort worthwhile. Moreover, effective financial supervision and robust financial sectors are a prerequisite for the further liberalisation of capital transactions as envisaged by the IMF and supported by us.

VI

Since last autumn the IMF has come under heavy criticism from some quarters - most unfairly in some cases. The proposals for improving the situation range from abolishing the IMF altogether to setting up additional institutions.

We can be certain of two things: Firstly, the IMF is now over 50 years old. When a human being reaches that age we say that he or she is still capable of doing outstanding work, has acquired great experience but, of course, is not infallible. Secondly, the overall setting has changed tremendously in the past decades. The world has long since moved away from fixed exchange rates with limited capital transactions. Today the exchange rates of the major reserve currencies are flexible and the markets are becoming increasingly integrated worldwide.

But I do not believe that the Fund's age and the changed setting mean that the IMF is superfluous. On the contrary! In this context I would like to draw your attention to the fact that we in Germany have already notified the Fund of our agreement to an increase in our quota in order to strengthen the financial basis of the Fund's activities.

But, of course, providing money is not enough. An interdependent, global economy requires not only efforts to achieve political cooperation but also vigilant watchdogs. In the first instance, it is the market players themselves who are responsible for exercising vigilance. It is *not* the Fund's task to take over or replace the watchdog function of the markets.

But in improving the functioning of the financial markets, the IMF also pinpoints the responsibility of the private investors themselves. For this reason the IMF must concentrate on its original function of acting as a catalyst. This central role of the IMF needs to be strengthened rather than reduced. In performing this role, the IMF will contribute to enhancing the stability and openness of the global economy. That is a challenge for at least another 50 years!