Part IV

The Role for Market Participants and Financial Authorities

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Promoting Financial Stability: The Role of Central Banks

Age Bakker

Promoting financial stability is not just another mission of central banks. Indeed, while central banks have had increasing success in safeguarding monetary stability, their concerns about financial stability have risen together with the growing systemic dimensions of financial crises.

I will discuss the nexus between two main central bank missions, price stability and financial stability. Targeting both stability goals at the same time can be challenging to policymakers. I will focus my remarks on the role central banks have to play in this respect, the policy instruments available to them and the new challenges that the increasingly systemic dimensions of crises pose.

The Nexus Between Price Stability and Financial Stability

Mr. Greenspan has defined price stability as inflationary expectations that do not significantly influence economic behaviour. Some concepts of price stability are more precise, like the definition of the European Central Bank, that stipulates price stability as an annual rise of the consumer price index of less than 2 percent in the medium term. A host of emerging countries have also adopted a well-defined policy objective by switching to an inflation targeting strategy (like Brazil, Chile, Czech Republic, Indonesia, Israel, Mexico, the Philippines and South-Korea).

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In a broad sense, financial stability may be considered as a situation in which the financial sector is able to mobilise savings and allocate funds efficiently and to absorb shocks without major damage to the real economy or other parts of the financial system. Financial stability can be distinguished in the concepts of micro stability, which involves the health of individual financial institutions, and macro stability, which focuses on the health of the financial system as a whole, including the interrelationship between financial institutions, payment and settlement systems and financial markets. The costs of financial instability can be high, especially in emerging markets, where financial buffers to absorb shocks are much smaller.

So how do these objectives of price stability and financial stability fit together? Traditionally, it has been assumed that price stability contributes to financial stability and vice versa. However, the issue is more complex. Indeed, the 1990s taught us that price stability is necessary, but not sufficient to safeguard financial stability. The 1997/98 financial crisis in Asia is illustrative here. In the run-up to the Asian crisis, large imbalances were built up in the real estate and other asset markets, although inflation was relatively low.

The Role of Central Banks

Can central banks deliver both stable prices and financial stability simultaneously? In my view, there are three ways in which the central bank should be involved in financial stability. These include the identification of vulnerabilities in the financial system (by monitoring risks), the analysis of the transmission of shocks in the financial system (analysing transmission channels, financial market behaviour) and the implementation of policies to make the financial system shock resistant. Such policies will include public disclosure rules, transparency standards, supervisory rules and the like. Let me briefly mention the main other instruments central banks have available to foster the separate objective of financial stability.

The central bank by its nature is involved in policies to mitigate the negative impact in the unhoped-for event of a financial crisis. Besides the use of the interest rate, financial stability can be supported in a number of other ways. One of these, of course, is the lender of last resort instrument. Traditionally, this instrument is available to support individual institutions. Besides, liquidity injections may be given to the financial system in general. This function has become more important, because of the increasingly systemic dimensions of financial tensions.

The organisation of a deposit insurance system is important to safeguard confidence in the financial system. By (partially) guaranteeing bank accounts, the risk of bank runs is reduced. Oversight of payment and settlement systems is also a key element in the financial stability policy of central banks. Mutual credit and liquidity risks have been reduced significantly by the implementation of real time gross payment systems, like Target in the euro area.

The aftermath of 11 September provides a recent example of the use of central bank instruments in relationship to the maintenance of financial stability. The Eurosystem provided no less than 110 billion to support the liquidity of banks. Moreover, the Fed and the ECB cut interest rates with 50 basis points. This was a display of complementary interaction between monetary and financial stability instruments as well as good international cooperation between financial stability authorities. This could avoid a systemic crisis.

Challenges

Although central banks are not always responsible for supervision, they are often involved in designing or advising on the regulation. Safeguarding financial stability requires a changing focus of supervision. Traditionally, prudential supervision is designed to work bottom-up, focusing on individual financial institutions. However, to serve the stability of the financial system, supervision should also have a top-down point of view. Such a design focuses supervision on systemic risks of failing institutions and the macroeconomic costs of these outcomes.

In emerging markets in particular, supervision issues rapidly take on systemic dimensions since a few financial institutions are dominant. In such a situation, it may be advisable to concentrate the guardianship of both financial stability and price stability within one institution, the central bank. Such a model has another advantage, since it combines financial expertise that might be sparsely available in emerging markets.

Central banks are continuously being challenged to deliver both price stability and financial stability. The increasingly systemic dimensions of financial activities pose new challenges for financial stability authorities. With the ongoing process of financial deepening and increasing cross-border financial synchronicity, systemic aspects are raising the stakes. Fortunately, central banks have an extensive toolkit at their disposal. Indeed, the swift reaction after the 11September 2001 events shows that policymakers are up to the job.

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The Lack of Stable Capital Flows to Developing Countries

Stephany Griffith-Jones

I want to make two short caveats before I start. First, the title of this session is "Fostering Global Financial Stability", and I think we should change it into "Fostering Global Financial Stability and Growth", because we need to think about how the global financial system can provide both important public goods. It is often forgotten in the discussion that the ultimate aim is growth and employment and so on, although of course such aim is embedded in Article 1 of the IMF.

The second caveat is that it was surprising that so much of the discussion has been at the national and regional level, important as these are, because the traditional Fondad focus has always been on the global level, and there has been a lot of pioneering discussions in Fondad meetings. Rather than being a criticism, I would urge Fondad to continue in this tradition.

We have had a very interesting discussion, certainly at the regional and the national level, and before I go to the international dimensions, I just want to make a point about Argentina. We have not really learned lessons. In the current Argentina crisis there is much in common with what happened in the early 1980s: short-term foreign exchange liabilities, fixed exchange rates, and so on. So we have to ask the question, all of us, at the national and international level, public and private: how can we learn from experience and how can we transmit this experience, so that we do not have another crisis again in ten years which looks exactly the same.

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Going to the issue of the pursuit of international financial stability, there are two aims. The first is the pursuit of financial stability *per se*, that is, the agenda of crisis prevention and management. The second is the provision of sufficient capital flows, both private and public, to different categories of developing countries to help sustain growth.

The Pursuit of Financial Stability

On financial stability, we concluded that progress has been insufficient, asymmetrical and also that there have been important reversals. I want to talk a bit more about the reversals. One of the reasons – I don't know if it is the main one, but certainly it is a very important reason – why the Argentinean crisis was so deep and has continued for so long, is that there has been a reversal in international financial governance. The Argentinean crisis happened to occur at a time when the developed countries, and particularly the US, became unwilling to continue large IMF lending packages to manage crises and, at the same time, there was no framework for orderly debt workout in place. Argentina was just very unlucky; it had a lot of its own problems, but it happened to fall in a 'lacuna', or institutional vacuum. Yung Chul Park was complaining that it took Korea ten days to sign an agreement with the IMF; six months after the start of the Argentinean crisis, there is still no agreement.

Argentina's difficulty in obtaining IMF lending has to do with an overstating of the problem of moral hazard. Moral hazard is a problem, but I don't think that financial markets' exuberance is only due to the fact that the IMF lends. Because we have had lots of crises, starting for example here in the Netherlands with the tulip crisis in the 17th century, when there was no IMF and the markets were still very exuberant with boom-bust patterns and so on. So we should not overstate the problem of moral hazard.

Two points on why the IMF has been so slow. There is a parallel with East Asia. The IMF has demanded a number of structural reforms from the Argentinean economy. Many of them are probably necessary. But it is not a good moment to do structural reforms in the middle of a crisis. You first have to deal with the crisis and then you do the structural reforms because they take a lot of time and are particularly difficult to do in a crisis. This is a point that we discussed during the Asian crisis. The IMF itself recognises this mistake in some documents it has produced, but it is not applying the lessons. The second point, which was also recognised in this nice evaluation the IMF did on East Asia, is that you have to be careful how much fiscal adjustment you require in times of crisis. Because when there is a dramatic fall of GDP, this leads of course to great difficulties in tax collection and getting enough fiscal revenues. Therefore, if you are too demanding, you deepen a recession.

On other issues of progress in international financial reform, I just want to make the point that a number of people – particularly colleagues from Asia – have talked about the lack of a global financial regulator. There has been a quite brave step in the creation of the Financial Stability Forum and other attempts, but they are weak and they don't represent developing countries. Yet this attempt to improve global financial regulation is important because, however one might want to criticise the IMF and other institutions for being insufficiently democratic, one of the deepest flaws in democracy – also something I learned in a Fondad meeting – is the lack of accountability of markets. There is no democratic accountability, and the only, very technocratic, way of doing it is through regulation.

The Provision of Sufficient Capital Flows

I want to talk about a second area of concern. We used to complain about the fact that we have too much volatile capital flows, and some are still talking about it. But the key problem that most developing countries at the moment are facing – not Eastern Europe – is the lack of sufficient capital flows. And having criticised the IMF, I will now use their data on capital flows to developing countries because they are the best ones we have. If you look at the build-up during the 1990s of net capital flows to emerging markets, you see that they peak in 1995-96 at more than 200 billion dollars, then they fall sharply, and they have stagnated for the last five years at around 60 billion. This is a dramatic fall and I think the next crisis may be the result of insufficient flows. We have to start adapting the discussion and the understanding of policies to this new reality.

A first question to ask is: Is this just a cyclical thing? Is this the memory of the recent crisis, the slowdown of the US economy, and so on? Is it just a cyclical reversal that will go away with time? Or are there important structural elements? I think there are important structural elements, which I will go through quickly.

One is the fact that banks have crossed the borders and prefer to lend in local currency, and therefore lend less in foreign exchange. Another, and worrying, structural element is that one of the few regulatory changes that have been pursued is the revision of the Basel Capital Accord. That revision may actually institutionalise the unwillingness of banks to lend to developing countries because it is going to use banks' own risk models to determine the level of capital requirements. And by using the banks' own models, it will make high risks more costly. As developing countries are perceived as high risk, they will have to pay more. Second, it will make lending even more pro-cyclical. In equity and bond markets there is a problem that, to the extent that these flows are increasingly going to the private sector, people in the market are saying, that there are not enough suitable borrowers or companies to invest in because they have either been privatised or they have been sold to foreign investors, and in some small or low-income countries there are just not a lot of large companies. These days it is very hard to find fund managers specialising in emerging markets or particularly in low-income countries like Sub-Saharan Africa. There seems to be a greater recourse to global fund managers investing a little bit of their money in emerging markets, which makes it – as a recent IMF report pointed out – more unstable because investors move very easily. When they see problems in emerging markets they pull out their one or two percent which they have in those markets very quickly and put it back in US or European paper. You don't buy to hold, these people say, it is more the case that you buy and sell all the time. The intention is increasingly short-term, except for FDI, which is the only good and important part of the story.

So the question is whether the presence of foreign companies, banks and other investors brings the developing countries the foreign exchange they need. If the capital flows do not come then the whole point of making efforts to attract private flows through liberalising the capital account and privatisation would be quite futile because you would only get the expertise – which is important – but you would not get the complementary foreign exchange. Therefore, a new challenge for the international community is to design measures – both in the receiving countries and in the source countries – on how to encourage sufficient stable flows to developing countries.

How can we mix public and private guarantees, possible subsidies, tax incentives and so on, both globally and regionally, to try and encourage sufficient flows to developing countries?

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Private Sector Views on Financial Stability

Frans van Loon

Let me give you some views from the private sector. First, I will share a thought from my institution and myself and then I would like to relay the main points that we have collectively agreed on in a large group of banks, the Institute of International Finance, with regard to private sector involvement in financial stability (and growth).

My first general point is that ING, as a large financial institution involved with the whole range of finance and a large number of individual clients, with lots of contacts, and with thousands if not hundreds of thousands of clients all over the world, is very aware of the deep unease so broadly felt about the development process, about globalisation, and specifically about the role of finance in globalisation. The concern is there, we do not deny it, and it is a real concern that is related to the dominant role that finance has played in globalisation as the most globalised of all the economic sectors.

With the benefit of hindsight, we see that the attention of the last ten years or so has been heavily focused on the cross-border elements of the internationalisation of the financial system. That is where we, the financial sector, have put our people, where we have put our assets, where we bought companies, and where we put our thinking power. It has been placed in promoting cross-border flows in the securities area, in corporate financing, in the bond area, in the equity markets, in the financing of trade. This was all wonderful business, and it was extremely profitable and exciting – for a while.

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But the situation has changed and, looking back, I think we have focused too much on cross-border flows. It has been overdone in the sense that we neglected to put enough focus on the primary necessity of strengthening domestic financial markets, domestic systems, and domestic institutions – for it own sake, and also as a necessary basis on which to base stable international flows.

We in the financial sector now see the necessity to focus on domestic financial systems in the broadest sense much more clearly than before: payment systems, transfer mechanisms of every type, institutional savings. At ING, we emphasise this broad sense, being an institution that is an integrated financial services institution, not a bank; we want to cover the whole range of financial instruments. This new view is rather deeply felt and it translates into clear changes in strategy of our institution and quite a number of other institutions, but it also leads to a diversion within the group of financial sector institutions.

Within the Institute of International Finance I see a divergence between the few strong big international players in cross-border flows, certainly in the capital market area – the investment banks in New York, who are usually very dominant in the international discussion – and us, the more integrated financial services organisations, located mainly in Europe. We have a broader range of interests and are not so much focused just on the international bond issues and the intermediation of international flows, we have a broader range. There is also a divergence because of the increasingly strong role of the holders of the assets, the bondholders: pension funds, insurance funds, and all of the various mutual funds. They are generally taking a much more independent view, independent especially from the investment banks.

What have we decided collectively within the Institute of International Finance? Even though the IIF is a group that ranges from the big Wall Street investment houses to the integrated financial service companies, the emerging markets banks and everybody else, we still reach pretty good consensus on the main lines. Interestingly, the first big point we all agree on is the necessity of domestic financial sector development. This is accepted by everybody as the main emphasis, because weak financial systems have been at the centre of broader economic crises in emerging markets too frequently.

The second point we agree on is that of technical arrangements to reduce risks, which includes three areas for action. The first area is the need to improve investor relations. It has been often emphasised by the private sector that there is a need to have a continuous exchange of views and information between the official sector and the whole range of private sector institutions, about government debt, the public finances, etc., so that the holders of bonds, the short-term, the long-term, the medium-term investors, all of the people in the private sector involved with putting up cross-border positions in a certain country, have access to the authority in a structured and organised way. That has generally been lacking in the past, now it is quickly improving. For instance, Mexico is doing a great job in this as are many other countries. It is a big point for us to emphasise the need for those investor relationships. Of course the same story goes for the transparency of macroeconomic and financial data and the dissemination of these data – which is a second area. A lot of progress has been made here, but it still remains a key point, closely related to the first.

The third area is the old idea of contingent credit lines to prevent financial crises. Unfortunately, it has not really worked very well. Countries considered it a sign of potential problems and weakness. There have been certain misgivings about contingent credit lines, both within the IMF and the private sector, but we think they again deserve attention as do public-private cooperation schemes. There are ways that risks can be shared that should not be forgotten.

Finally, I come to the third and key point of an orderly sovereign debt restructuring process. We see three lines of action.

First, strong emphasis should be placed on the consultative element. The lack of consultation with the IMF has always been a complaint of the private sector, partly as a result of the secrecy element of IMF consultation with member countries. This is already changing; there is a private sector contact group. It needs to be expanded, institutionalised and broadened because the range of financial products present in cross-border exposure is wide, much wider than in the 1980s. We need to work on a strong consultative process between the private financial sector and essentially the IMF.

The second line of action is the contractual element, which really means working on the collective action clauses. Much work has already been done, and most of us want this to happen; the large European and American borrowers need to get on board, we have to push that practical steps are advanced to include collective action clauses in bond and loans contracts.

The third line of action is a legal element, where we need to put some teeth into fighting those creditors who are against conforming to the majority. We need a targeted legal strategy to address vulture funds and limit disruptive litigation stemming from holdout creditors.

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Fostering Financial Stability: The Role for Ministries of Finance

Wouter Raab

I will identify four types of intervention that ministries of Finance can use to foster global financial stability: (i) participation in international financial institutions, through which the international financial system is managed; (ii) keeping their own house in order by pursuing sound and credible fiscal policies; (iii) fostering trade liberalisation and improving market access; (iv) adequate financial market regulation and (particularly in Europe) financial market integration.

The Netherlands being a small and very open and internationally-minded economy, the Dutch Finance Ministry sees its role primarily through the active participation in the multilateral fora and institutions that are dealing with financial stability, such as the IMF, the World Bank, the Financial Stability Forum and the Financial Action Task Force on Money-Laundering. We believe in a strong rules-based international system, where there is equal treatment and in which every country has a voice. Only such a system can take decisions that are effective, legitimate and that will find the widest possible support in the international community. For us, the IMF, with its almost universal membership is the central institution for global financial stability. The G-7 can never substitute for that, because of the inherent limitations to the G-7 concept.

Global financial stability is high on the agenda on the IMF, notably through the work on crisis prevention and on crisis management. Making countries' financial systems stronger and more

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resilient and promoting transparency by disseminating more financial data is the aim of the many standards and codes the adherence to which the IMF is monitoring, notably in the so-called Report on the Observance on Standards and Codes (ROSC). In addition, the IMF's Financial Sector Assessment Programme (FSAP) reviews the strengths and weaknesses of a country's financial sector. Although the participation in these exercises do make a heavy demand on the often limited resources of emerging market economies, the benefits are also clear: reform of a financial sector so that international standards are fully or almost met, will improve a country's creditworthiness in the international capital markets.

In the field of crisis management, efforts in the IMF have focussed on the wider introduction of so-called Collective Action Clauses in bond contracts and the design of a Sovereign Debt Restructuring Mechanism (SDRM), through which sovereign debt restructurings can take place in a more orderly manner than has been the case so far. Particularly, the work on Collective Action Clauses has been relatively successful, given its much wider use recently. While it has been difficult to find agreement on the SDRM among the IMF member states, the discussion has led to a better understanding of the crucial role of transparency and of early and continuous communication between debtors and creditors, particularly in times of stress, when a debtor country has (or is perceived to have) difficulties in repaying its creditors. In this context, proposals for Codes of (Good) Conduct have been made by the Institute of International Finance and the Banque de France.

A second element of how ministries of Finance can contribute to global financial stability is to keep or put their own house in order. Sound fiscal policies are key to this. Developed countries in particular should commit themselves to sustainable fiscal positions. Credible medium- and long-term fiscal strategies and their implementation will lead to lower long-term interest rates. As most public budgets in developed countries will be burdened by rising costs because of the ageing of their populations, most countries still have some work to do. Failure to put public finances on a sustainable footing will not only lead to higher interest rates, but also to a situation where international savings will be used to finance public deficits in the developed world, rather than financing investment in developing countries. In Europe, the Stability and Growth Pact provides for a well-defined process of multilateral surveillance and peer pressure with the explicit aim of ensuring both medium and long-term sustainability of public finances.

A third element is the advocacy role of ministries of Finance, in particular regarding trade liberalisation and access to trade for developing countries. Greater access to trade would make developing countries less susceptible to shocks in private capital and reversals in ODA flows and so could lead to greater stability. Most ministries of Finance do not have a direct responsibility for trade issues, but, given their central role in economic policy-making, both nationally as well as internationally, they have an important role to play in focusing the international community in taking actions to move forward with trade liberalisation. In particular, the reduction of agricultural subsidies in developed countries needs to be addressed, since they burden the budgets of developed countries as well as prevent developing countries from exploiting their comparative advantages.

Last, but certainly not least, ministries of Finance are responsible for the regulation of their national financial markets and for providing the institutional structure for supervision of domestic financial markets and institutions. In the aftermath of the past stock-market bubble and in the post-Enron world, the need for adequate regulation of financial markets, supervision and for strengthened accounting standards and improved corporate governance is almost self-evident.

In Europe, there is a strong drive to financial markets integration to arrive at a fully integrated single European financial market. In 1999, EU ministers of Finance adopted the Financial Services Action Plan (FSAP). It has three main strategic objectives:

1. to establish a common legal framework for integrated securities and derivatives markets; financial integrity is a cornerstone of this objective;
2. to establish open and secure retail markets;
3. to have state-of-the-art prudential rules and supervision.

A deeper and more liquid EU-wide capital market will be able to provide participants from inside or outside Europe with more tailor-made financial instruments, will facilitate access to credits at lower costs, and will be able to absorb shocks better.