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Stability of the International Financial Sector

CONSIDERATIONS OF REFORM WITH REGARD TO THE INTERNATIONAL FINANCIAL ARCHITECTURE

POLITICAL AND SECURITY IMPLICATIONS OF FINANCIAL CRISES

This year's financial turmoil which had its origin in a tumbling US housing market had severe negative impacts not only in the US but also on global financial markets. But history proves that developments in financial markets can have much more far-reaching consequences not only for markets but also for politics, societies and national as well as international security – in a positive as much as in a negative way:

Examples from Germany

Germany delivers two striking examples for an answer:

1. Following the creation of the German Empire in 1871, a single currency based on the Prussian currency standard and later linked to gold was introduced and the Berlin-based Preußische Bank was turned into the new central bank of the Empire. This helped creating a climate of political stability and regulatory certainty in the financial sector, what became an important factor for the economic success and political solidity of the new German Empire in its first decades.

2. A clearly negative example is Germany after the shocking stock market crash in 1929. The world economic crisis resulting from that led to a tidal wave of insolvencies, massive unemployment and broad poverty in all kind of society segments in Germany. These were decisive catalysts for a development which enabled a further rise of anti-Semitism and political extremism, particularly fascism, in Germany and ended ten years later in World War II.

Examples from Asia

It is unfortunately in Asia where we find another striking example from the recent history for a crisis which posed not just widespread financial economic but also political and security implications. The Asian financial crisis of 1997/1998 has washed away decades of economic growth, social achievements and poverty reduction especially in Thailand, Indonesia and South Korea. Hundreds of thousands of workers in these countries had lost their jobs with little social security support beyond that by families and friends. The crisis deepened the marginalization of these poor and vulnerable groups.

Simultaneously the crisis had stimulated new political currents in many parts of the region.

Political dissent and social unrest increased. In some countries like Indonesia, people started questioning the legitimacy of governments which has been built upon their economic performance. Criticism of the government's management or sensitive issues like corruption has been met with a hardline response by the government. Military officials had publicly equated currency speculation and food hoarding with subversion, an offence punishable with death. The media had been attacked for its allegedly negative reporting. Hundreds of peaceful critics had been rounded up, many of whom

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have been charged under various laws. At the same time the Malaysian authorities had stepped up operations to stem the tide of economic immigrants from Indonesia who were fleeing escalating unemployment, food shortages, rising prices and social unrest in Indonesia. Thousands of illegal Indonesian immigrants were deported back into their country, sometimes under quite harsh and violent circumstances. Equally, particular in Indonesia, ethnic Chinese minorities had to face intimidation, harassment and even fatal mob attacks on account of their prominent position in the local economy and deeply entrenched suspicions in prejudice.

Experts are concerned that, as with other Asian countries, a major economic downturn, not to mention economic collapse, might produce a political crisis even in a big and powerful country like China. A deepened recession in Japan in combination with a similar crisis in China may bring about economic and political turmoil all over East Asia. This could trigger a wave of nationalism, xenophobia and economic protectionism rippling through the region. It may as well lead to a demise of regional organizations like APEC or ASEAN plus 3. The absence of such cooperative structures and the weakening of traditional alliances may make Asia even less stable and more prone to conflict – a frightening scenario which will hopefully never become reality.

Reasons for the Asian Crisis 1997/98

To avoid future crises we should try to learn from the past. Experts consider a combination of factors responsible for the outbreak of the Asian financial crisis. The most immediate cause was an investment boom bubble, combined with a massive, volatile inflow of mainly short-term foreign capital and a weak banking system under inadequate supervision. The fragile banking system in East Asia simply could not withstand the onslaught of speculative international capital.

The crisis revealed the fundamental weaknesses in the underlying conditions of countries that had long been heralded as the development miracles of the late 20th century. The governments of several rapidly growing economies had implicitly supported widespread mismanagement and chronically weak regulation of financial activities, a by-product of the collusion between public and private interests to promote overseas internal investments and highly competitive trade sectors. The tragedy occurred because, although these economies were not big, strong and stable, they opened up their capital markets. In hindsight, they should have opened their capital markets according to a properly sequenced schedule. But they apparently simply miscalculated the force of globalization.

THE CURRENT INTERNATIONAL FINANCIAL ARCHITECTURE

The global level

It was back in 1944 that global financial players tried to react to the risk of financial crises by setting up the principal pillars of an international framework in form of the Bretton Woods institutions. That has been 63 years ago but the key aim of today's policy makers has not changed compared to those at the Bretton Woods times – it has been, and still is, global prosperity and stability. But the environment in which we are acting has changed profoundly.

The founders of the International Monetary Fund (IMF) and the World Bank wanted to create institutions that prevent countries from falling back into autarky and protectionism and that help them to raise growth and increase stability in a world of fixed exchange rates with still a large degree of capital controls. Today we are striving for stability of the international financial system in a world of free capital flows with an overwhelming importance of private flows and increasing trade and financial integration. Among the major factors that we have to take into account, I would like to mention in particular:

The financial globalization phenomenon: capital market liberalization, both domestically and internationally, technological advances and buoyant financial innovations have contributed to set up a totally unknown degree

of financial globalization – with great benefits, but also new risks.

The policy responsibility which still lies mainly with sovereign states; thus, the challenge is to promote global financial stability very largely through national actions enlightened and coordinated through a larger degree of intimate international cooperation. A very large consensus on giving the private sector and markets a central role on the one hand, and relying upon sound public institutions to provide market participants with the appropriate environment on the other hand. This shift from direct public involvement to private activities is particular striking when looking at financial flows to emerging markets: in the 1980s, official flows were dominant, reaching on average over 60% of total flows to emerging markets. By contrast, the 1990s saw a dramatic increase in private flows, which on average accounted for around 85% (in the period from 1990 until 2003). Equally important is the shift from bank loans to negotiable securities as the major financing tool for the developing countries.

It was on the basis of the experience with the Mexican crisis in 1994/95 that there grew a common understanding that called for

- enhancing transparency and accountability
- strengthening domestic financial systems
- managing international financial crises, namely by crisis prevention as well as crisis mitigation and resolution and pushed international financial institutions to more effectively take care of surveillance, assistance as well as standard and code setting.

Surveillance and Assistance

In this context of the international financial architecture the International Monetary Fund is in the focus.

It is an international organization of 185 member countries, located in Washington. It was established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment. Since the IMF was established its purposes have remained unchanged but its focus has been shifted much more toward crisis prevention and its operations—which involve surveillance, financial assistance, and technical assistance—have been considerably reformed to meet the changing needs of its member countries in an evolving world economy.

Surveillance
In today's globalized economy, where the economic and financial policies of one country may affect many other countries, international cooperation to monitor economic developments on a global scale is essential. With its nearly universal membership of 185 countries, IMF surveillance provides the mechanism for this cooperation.

The importance of effective surveillance was underscored by the Asian financial crisis. In response, the IMF has undertaken many initiatives to strengthen its capacity to detect vulnerabilities and risks at an early stage, to help member countries strengthen their policy frameworks and institutions, and to improve transparency and accountability.

Let me mention the most important examples: Exchange rate, monetary and fiscal policies remain at the center of IMF surveillance. The IMF provides advice on issues ranging from the choice of exchange rate policies to ensuring consistency between the regime and fiscal and monetary policies.

Financial sector issues have received greater emphasis under IMF surveillance. This enables the IMF to assess the strengths and weaknesses of countries' financial sectors. Assessment of risks and vulnerabilities stemming from large and sometimes volatile capital flows has become more central to IMF surveillance in recent years. While crisis prevention has always been a focus of IMF surveillance, the growth and development of global capital markets has made it necessary to expand the scope of surveil-

lance to encompass complex financial relationships.

Institutional and structural issues have also gained importance in the wake of financial crises and in the context of some countries' transition from planned to market economies. The IMF, but also World Bank play a central role in developing, implementing, and assessing internationally recognized standards and codes in areas crucial to the efficient functioning of a modern economy such as central bank independence, financial sector regulation, and policy transparency and accountability.

A prominent institutional newcomer is the Financial Stability Forum (FSF), which was set up in 1999 to enhance policy coordination among national financial supervisors, the International Financial Institutions, and international standard setters with the aim of promoting international financial stability. Its creation came also as a major response to the financial crises of the late 1990s. They had exposed numerous weaknesses in the interaction of national authorities in charge of supervision and regulation of financial institutions operating in increasingly globalised markets and had underlined the need for improved information-sharing and harmonisation of national rules. Already one year after its creation, the FSF presented important findings and policy recommendations on three key systemically relevant issues, namely risks stemming from large and volatile capital flows, concerns relating to offshore financial centres, and highly leveraged institutions. The FSF is serviced by a small secretariat housed at the Bank for International Settlements in Basel, Switzerland.

Financial Assistance

Over the years, the IMF has developed various loan instruments, or "facilities," that are tailored to address the specific circumstances of its diverse membership, mainly to address balance-of-payment- problems, e.g. in form of the so-called Poverty Reduction and Growth Facility (PRGF), the Exogenous Shocks Facility (ESF) or through Stand-By Arrangements (SBA) and the Extended Fund Facility (EFF). The IMF also provides emergency assistance to support recovery from natural disasters and conflicts. New facilities have been added in recent years to enhance the IMF's ability to respond to crises. In 1997, the Fund introduced the Supplemental Reserve Facility to assist countries experiencing exceptional balance of payments problems created by a short-term financing need arising from a sudden loss of market confidence. In 1999, it introduced the Contingent Credit Lines (CCL), an entirely new approach aimed at crisis prevention. It makes financial assistance potentially available to countries concerned about their vulnerability to contagion, but not facing an imminent crisis.

A special issue in the late 1990s had been the complaint against IMF that it would favor moral hazard among recipient governments and private investors by bailing them out in financial crisis via further loans, increasing by that the country's debt load in an irresponsible way. This led to increasing discussions about the appropriate involvement of the private sector in crisis management and, as a result, to considerable progress in the international financial architecture.

First, specific criteria and procedures were set up to make exceptional access to IMF resources subject to rules and hence more predictable. The IMF's debt sustainability analysis plays now an important role in that context, since clear limits to official financing must be respected especially when a country faces an unsustainable debt burden and therefore requires debt restructuring.

Second, so-called Collective Action Clauses (CAC) have become more and more standard in newly issued international sovereign bonds. These CAC have the aim to create a legal framework within which creditors and debtors could achieve more orderly debt restructuring.

Although this put more financial risk burden on investors no discernible negative impact on borrowing costs and no decrease in investors' interest could be detected.

Technical Assistance
The IMF provides technical assistance mainly in its areas of core expertise: macroeconomic policy, tax policy and revenue administration, expenditure management, monetary policy, the exchange rate system, financial sector sustainability, and macroeconomic and financial statistics. But there are also other international financial institutions delivering assistance and support to developing countries in financial matters. The World Bank is closely cooperating with the regional developing banks (Asian, African and Inter-American Development Bank). All these multilateral banks undertake comprehensive activities to strengthen the financial sectors in developing countries.

Debt relief
Additionally World Bank, in cooperation with IMF and donor countries, started an important debt relief initiative in form of the Heavily Indebted Poor Countries (HIPC) Initiative in 1996. This meanwhile enhanced HIPC Initiative is designed to provide assistance to eligible countries that are following sound economic policies, to help them reduce their external debt burdens to sustainable levels in a way that promotes effective poverty reduction. The enhanced HIPC initiative is now complemented by the Multilateral Debt Relief Initiative (MDRI) established in 2005 under whose roof World Bank, IMF, the African Development Fund and since shortly also the Inter-American Bank provide full debt relief to the circle of eligible countries.

Standard and Code setting
It has been a very important development in the financial architecture that the international community has strongly supported the generalization of standards and codes. The various standard setting bodies, including

- Basel-based committees, namely the Basel Committee on Banking Supervision (housed
- by the Bank for International Settlements) with its Basel II Framework focusing on capital adequacy and risk management,
- IMF and World Bank and
- Financial Action Task Force on Money Laundering, established by the G7 in 1989,

have managed to develop many international standards and codes, which have been agreed upon by a rising number of countries. These standards and codes cover a broad range of fields such as transparency in fiscal, monetary and financial policies, banking supervision, corporate governance, accounting and auditing and reflect the growing interaction between the macroeconomic and the financial sphere. Moreover, compliance with international standards and codes makes national policies more transparent and mitigates the risks of disruptive developments. All of these effects contribute to the resilience of national economies as well as the global financial system. One of the challenges that the standard-setting bodies are faced with is to ensure that the various standards and codes are mutually consistent and regularly updated so that they keep pace with the changing global financial environment.

Global political dialogue

As you see e.g. with the just mentioned Financial Action Task Force on Money Laundering, the G7 has been instrumental in shaping the international financial architecture as it reacted to the need to better involve emerging market economies. The creation of the Group of Twenty (G20) forum of finance ministers and central bank governors in 1999 was inspired by the necessity to give major emerging market economies their place and have them participate in a dialogue on global macroeconomic and financial issues. This new international forum brings together representatives from 19 industrialized countries and emerging economies as well as the European Union and the Bretton Woods Institutions. As regards the promotion of global economic and financial stability, which is its main aim, the G20 has been a remarkable forum for serious dialogue on a wide range of highly relevant issues such as exchange rate regimes, prudent debt management, domestic financial deepening and international codes and standards.

Peer review of members' policies has been a helpful approach used by the group. The G20 has also played an important role in

forging consensus on reforms of the Bretton Woods institutions and has been constructively involved in helping shape new mechanisms of crisis prevention and resolution.

The regional level in Europe and Asia

The international financial architecture does not only consist of a global level but also reveals important integration approaches on the regional level. Nevertheless their depths still differ very much from continent to continent. Europe has already gone very far towards a complete and comprehensive financial and monetary integration whereas Asia has just taken the first steps in direction of this ambitious target.

Europe

Let me start with an interesting historical hint dating back to the already mentioned fateful year 1929: It was surprisingly already in that year that the then German Foreign Minister Gustav Stresemann requested the introduction of a European currency. Would World War II have happened with the birth of the Euro in 1929? We will never know – but Minister Stresemann's dream became true 70 years later with the establishment of the European Central Bank in 1998 and the European Monetary Union in 1999. From the start of 1999, the Euro became a real currency, and a single monetary policy was introduced under the authority of the European Central Bank. A three-year transition period began before the introduction of actual Euro notes and coins, but legally the national currencies had already ceased to exist. The Euro notes and coins were finally introduced in January 2002. Apart from that, in 2001, Greece and in 2007, Slovenia joined the third stage of the European Monetary Union as the 12th and 13th member state. The European Monetary Union is underpinned by the Stability and Growth Pact (SGP), adopted in 1997. It is an agreement by European Union member states related to their conduct of fiscal policy, to facilitate and maintain the Economic and Monetary Union of the European Union. The actual criteria that member states must respect include an annual budget deficit no higher than 3% of GDP (this includes the sum of all public budgets, including municipalities, regions, etc.) and a national debt lower than 60% of GDP or approaching that value.

One should not forget that this impressive financial and monetary integration process happened, in contrast to Asia, with the background of an already economically and politically profoundly integrated European Union. Nevertheless the result was not only the most profound change in the international currency system since the transition to flexible exchange rates at the beginning of the 70s but also the largest monetary union in human history and one major factor in the integration and competitiveness of the European financial system. What D-Mark and Yen were not able to achieve in the 70s and 80s seems to become possible for the Euro today: to challenge the US Dollar as the so far undisputed international lead currency. The Euro has gained remarkable importance as an international trade-, investment-, anchor- and reserve-currency and could establish itself as the clear No. 2 behind an increasingly shaky US dollar.

Once the introduction of the Euro was secured, however, political attention has turned to making improvements to the single market in financial services for it was understood that greater integration on the financial markets was crucial to the success of the Euro and to European Economic and Monetary Union. In order to create an adequate framework for this market, equally in 1999, the Financial Services Action Plan (FSAP) had been installed by the European Commission as a vehicle for developing the European Single Market in financial services. It has three objectives: a single wholesale market, an open and secure retail market and adequate prudential rules and supervision. It comprises 42 measures designed to harmonize the member states' rules on securities, banking, insurance, mortgages, pensions and all other forms of financial transaction.

It is complemented by the so-called Lamfalussy-process (elaborated by an expert panel chaired by Baron Lamfalussy), an approach designed to speed up the legislative

process and to foster supervisory cooperation in the EU.

But a lot still needs do be done. Integration of EU financial markets is hampered by the failure of too many member states to act on the commitments they agreed to in the framework of the FSAP and the Lamfalussy-process. So the vision of an integrated EU market for financial services has only been marginally implemented – a fact which reduces the EU's competivity and growth perspectives in an unnecessary manner and implicates a so far missed chance to further increase the EU's financial stability and investors' trust in EU's financial markets. What is already needed today but will still need considerable time to be shaped is a new strong and independent European Financial Services Authority with adequate competencies and powers.

Asia

The financial crisis in 1997/1998 was a wake-up call to East Asia governments that their financial markets and institutions were insufficiently prepared to manage globalized capital flows.

Apart from reforming domestic financial markets governments were encouraged to consider establishing regional financial facilities, as in their view the provision of international financial help through existing multilateral arrangements had been neither timely nor sufficient to put a rapid end to the crisis. Not only were the East Asians countries discontented with the IMF approach, but there was also growing consensus among them that a collective response to similar critical situations in future would be necessary because of their growing regional integration, evidenced in part by the mutual susceptibility to contagion. After first initiatives in form of the Manila Framework Group in 1997 and the ASEAN Surveillance Process in 1998, finally, in 2000, the finance ministers of ASEAN plus 3 (the 10 southeast Asian ASEAN members and China, South Korea and Japan) reached an agreement on the Chiang Mai Initiative, which was the first significant regional financing arrangement to enable countries to cope with disruptive capital flows and maintain exchange rate stability.

Under the Chiang Mai Initiative all participating governments were allowed to swap their own currencies for major international currencies for a period of up to six months. The idea was that a country under speculative attack can borrow foreign currency, usually the US dollar, from another partner country and use the funds to buy own currency so as to stabilize the exchange rate. Even with the fact that the amount of liquidity currently available through this initiative is relatively small it had a strong symbolic effect to market participants and it served as an important step towards establishing a pool where these countries invest part of their reserves to create new credit facilities for themselves. It was then at the annual meeting of the Asian Development Bank in Kyoto in 2007 that ASEAN plus 3 members agreed to an ambitious plan to pool part of the region's vast foreign currency reserves in form of a self-managed pooling arrangement to help secure cash for distressed nations in times of future financial crises. This agreement whose concrete arrangements have to be worked out in the coming years would expand the Chiang Mai Initiative and boost the arsenal of defensive funds remarkably. It would allow ASEAN plus 3 countries to first countering a local crisis themselves before resorting to outside help from IMF and others. This would surely mark an important breakthrough in financial integration for the region.

An interesting parallel initiative is the ASEAN plus 3 Asian Bond Markets Initiative (ABMI), which was endorsed at the ASEAN plus 3 Finance Ministers Meeting in Manila in 2003. It aims to develop efficient and liquid bond markets in Asia, enabling better utilization of Asian savings for Asian investments and reducing the dependence on US Dollar denominated US treasury bonds.

And there are already people bold enough to discuss a potential Asian Currency Union (ACU).

Japan seems to be the prime mover behind this ambitious idea but with view of Asia's

still low level of overall regional integration and of the current lack of international support for this vision this long and difficult ACU process will more likely take decades rather than years.

The future perspectives

As you have seen there are comprehensive approaches to a reformed international financial architecture on the global level as well as there is a rising trend to regional financial architecture models on a more or less advanced level.

The decisive question is now if these regional approaches can and should replace the architecture on the global level or if these different levels should be interlinked as closely as possible to reinforce each other optimally.

No doubt, there is considerable dissatisfaction with the global financial architecture, namely the IMF, particularly on the side of emerging economies. This cumulated in a recent speech given by the Russian president Putin during the World Economic Forum Russia in June 2007 in St. Petersburg where he requested a new global economic framework that would play down the role of institutions like IMF and WTO and instead would emphasize regional alliances. But critique comes also from other actors: The governor of the Bank of England, Mervyn King, warns that the IMF "could slip into obscurity"; the former IMF's Managing Director, Rodrigo Rato, called for more voting rights for IMF's Asian members, for a strengthening of the IMF's global ("multilateral") surveillance role and for a rethinking of its relations to the poorest countries of the world; important large-debtor countries such as Brazil and Argentina carry out an early repayment of outstanding obligations; due to the relative stability of the financial markets the IMF is losing some of its traditional functions and now, for the first time since the early 1970s, the declining interest income means that the IMF is once again faced with the prospect of deficits. Others argue that more and more countries have established sound and transparent policy frameworks. From that they draw the conclusion that policy dialogue at the international level therefore has lost its relevance and that the fora and institutions dealing with global financial issues have become redundant. These views ignore that, as I outlined above, the governance of the international monetary and financial system has been upgraded in a number of important ways to remain relevant and effective in the ongoing quest for global financial stability. Only one argument could rightly be put forward: that these reforms were not far-reaching enough. Of course, keeping one's domestic system in order and putting in place rules-based policy frameworks are decisive contributions to the stability of the global economic system. However, given the rising degree of global integration, these efforts alone do not eliminate the potential for spillovers from one country to another, adversely affecting the stability of the global system. In parallel proper regional approaches are to be welcomed any time because they support the regional financial integration, improve conditions for economic growth and wealth in the respective region and strengthen the region's competitiveness. But spill-over effects happen as well from one region to the other and that makes a solid, transparent and predictable global financial architecture so important. Policy cooperation at the international level is vital to strengthen the ability of the global economic system to absorb shocks and hence to deliver the public good of global financial stability. Therefore the key question is not if to go either the global, the regional or the domestic way. The truth lies in an international architecture which properly integrates structures and activities on the domestic, regional and global level. Of course a conditio sine qua non is that the various fora and institutions that form this international financial architecture on these three different levels are designed and constantly upgraded so that they are up to the task. This is an important and ongoing responsibility that policymakers from around the globe are faced with. Living up to this responsibility will ensure that, going forward, global economic integration will lead to further global economic prosperity and in parallel to more global stability.