Development and the International Financial Architecture

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Introduction

Let me start with a simple fact. The 1990s was a decade of successive financial crises and a decade of good macro-economic performance in most of the world. There was the Mexican crisis in 1994/95, the Asian crisis in 1997/98, Russia in 1998 and the LTCM-related crisis shortly thereafter. Each crisis was painful and disruptive. There was no shortage of predictions during each particular crisis that it would lead to some kind of global financial meltdown in which the scale of financial intermediation would shrink world-wide. But such fears happily proved unfounded. Policy makers’ crisis management can take some credit for this.

But the outcome surely also tells us something about the resilience of financial markets and institutions, even in countries where deregulation was still a recent experience. Part of this resilience can be attributed to the adequate cushion of bank capital that exists in most major countries. Big mistakes had obviously been made by many countries - including first world countries - in the development and management of the financial systems. Yet relatively few have chosen to go back to highly regulated systems. One reason for this is that free and dynamic financial markets can make an enormous contribution to growth. This is particularly true in developing countries. This is why I formulated my simple fact "a decade of crises and a decade of growth". The liberalisation of financial markets, increased capital flows, more dynamic financial institutions looking for profits probably contributed to this growth - even if, carried to excess, these same factors fuelled the crisis.

The task of public policy is to provide a better environment to make financial systems stronger but without crushing private initiative in extending finance, both domestically and internationally. This is the main aim of work on international financial reform.

In discussing this question, I will develop three themes:

(i) A pragmatic approach to building financial systems has the greatest chance of success. There is no magic solution. The establishment of the Financial Stability Forum in early 1999 indeed represented the choice of pragmatism in this area.

(ii) Developing countries need to manage external financing choices with great care. Before the crisis many of them were very naive about this. This subject was considered at some length by an FSF working group and I will summarise one or two of its conclusions.

(iii) The development of international regulatory standards will perhaps prove to be the most durable and productive legacy of the Asian crisis, and should make a major contribution to sustainable development.

Not a response to a unique crisis

The immediate impetus for the new international financial architecture came from the Asian crisis. Several countries which had enjoyed strong economic performance and which had been pursuing adequate fiscal and monetary policies as well as open trade policies were hard hit. This inevitably focused attention on microeconomic or structural weaknesses. And, because countries with stronger banking systems weathered the crisis much better, addressing banking sector problems was at the top of the list. Major reforms were launched, often as part of the conditions for IMF loans.
But as time has passed since the crisis, it is possible to detect a certain weakening of political support for what was always an ambitious agenda. The truly impressive recovery in many of the crisis-hit countries has not helped maintain resolve. Some have interpreted the coincidence of strong growth and weak or halting reform as evidence that the need for reform has been exaggerated. But Asia’s sharp recovery depended almost entirely on exports. It has made surprisingly few demands on the financial system, domestic or international. Current account surpluses have in effect removed the need for foreign finance. A sharp drop in business-fixed investment and a virtual halt to new construction meant little need for domestic finance either. Obviously these conditions will not last forever.

And in any case, the need for financial sector reforms had much deeper roots than the Asian crises that provided the trigger. Rather, it grew from an increasing awareness that far-reaching changes in the international financial system had undermined some old assumptions about international economic policy. This applies as much to industrial countries as to emerging countries. So much has been written about this and is now familiar that I can just identify five key changes.

(i) A healthy macroeconomy is not enough. In the past, international policy discussions were dominated by macroeconomics. IMF programmes, for instance, used to focus almost exclusively on macroeconomic conditions, typically with the aim of reducing current account deficits. Discussions about economic policy coordination among the G3 in the 1970s were couched in similar terms. With the liberalisation of capital movements, however, financial flows have become more important, and their relation to the real economy is much more complex. As a result of this,

(ii) Financial markets have become more global and more influential. With financial markets now more global, countries have to find ways to build credibility with financial markets. The official sector agenda in developing standards for strong financial systems has to be seen in this light... as a way of helping developing countries to build credibility. Standards did not of course create this need.

(iii) Financial markets spring surprises. The experience of past decades is that financial markets can be both volatile and subject to medium-term misalignments. For reasons that are not entirely clear, the self-correcting properties of markets have worked much more slowly than once hoped. This may be unwelcome but is unlikely to change soon. This experience has focused attention on the need for financial institutions to be robust enough to cope with difficult conditions. Equally, countries and institutions need to be prudent when international financial conditions are “too easy”: this has an important bearing on policies with respect to capital inflows.

(iv) Contagion more important. Financial markets typically provide much more powerful, quicker acting and - crucial point - more unpredictable channels of transmission than the traditional trade links. This is perhaps especially so for small countries without a track record in financial markets. It is almost inevitable that international investors managing diversified portfolios, not fully informed about each and every country, tend to group similar countries together. One implication of contagion is that an emerging market country needs to worry about the situation in other countries seen by markets as similar. In other words, they have a major interest in the quality of the reform in neighbouring countries.

(v) Greater diversity of actors. In the 1970s, private international capital flows went through the major international banks. These institutions were the focus of the Basel Committee’s work, which was - and still is - the most fully developed apparatus for the international coordination of financial sector regulation. But markets are now the major channel of international capital movements. Many different types of institution (mutual funds, insurance companies, pension funds, hedge funds etc) are now involved. It is no longer sufficient to focus only on banks. And financial institutions based outside the major centres have come to play a more important role in international markets.

The search for an optimal response

Unfortunately, however, setting out the weaknesses of the earlier mechanisms is much easier than proposing solutions. Indeed, a very vigorous debate took place during 1998 and 1999 on what
institutional changes were needed to manage this much more complicated international financial system.2 At a risk of great oversimplification, three types of approach were then advocated:

(i) Leave it to the markets. Countries that fail to sort out their financial system would be penalised. There is much merit to this point of view. But there are some powerful counter-arguments: (a) markets do not work well if poor disclosure practices mean that little information is available; (b) externalities related to contagion; (c) market behaviour can be distorted if government bail-outs in effect undermine the exercise of market discipline.

(ii) Create a super-regulator. This is the World Financial Authority of Eatwell & Taylor (1998). Again, there is some logic. As financial institutions themselves become more global, should not also regulators? The absence of a global regulator doubtless creates problems. Yet there are the very strong arguments for the case that for practical purposes regulation and supervision are better left as national responsibilities. One is that regulators must remain in close touch with the markets they are regulating. Another is that legal conditions differ greatly from one country to another.

(iii) Step-by-step initiatives to deal with particular problems. One of my colleagues has termed this "pragmatic multitherapy". This path has the merit of having been well-trodden. Many initiatives that came to have general significance for the international financial system were initially prompted by very specific concerns and were led by very few factors. Take the example of the elaboration of international cooperation on bank supervision under the auspices of the Committee on Banking Regulations and Supervisory Practices (to give the original title). International rules on capital adequacy originated in a joint proposal by the Bank of England and the US federal bank regulatory agencies in January 1987. This approach was then refined and extended to the G10 countries. Because these rules acquired a high degree of credibility with markets and because they were promulgated by the authorities in the major countries, many countries outside the G10 chose to follow them. They became an almost global standard not because this was the Basel Committees's ambition, but rather because an internationally accepted standard was needed.

So we have market, superregulator and pragmatic multitherapy. The debate between these three approaches raises such political and ideological issues that it was unlikely to be resolved to the satisfaction of any neutral economist. Each approach has theoretical pros and cons that could be long debated. In practical terms, however, the debate was settled in February 1999 when then - President Tietmeyer of the Deutsche Bundesbank persuaded the G7 to create a Financial Stability Forum (FSF) that would bring together ministries of finance, central banks, and major supervisory authorities, plus the International Financial Institutions (IFIs) and international standard setters. This proposal continues the well-established tradition of "pragmatic multitherapy". No grandiose new scheme. It was designed to build on existing institutions, which would remain fully responsible for their mandated tasks. It would try to enhance the synergies that could be achieved from a better pooling of information and points of view.

I would like to focus on two major issues addressed by the FSF. One is the management of capital flows, often singled out as a major cause of trouble. The second is the development of international standards for financial systems.

Managing the volatility of capital flows

First, capital flows. An FSF working group on capital flows, chaired by Mario Draghi, was published last year. The basic premise of the report was that the free movement of capital internationally is desirable. It helps both the efficient international allocation of saving among countries and the diversification of risks. But the report did recognise that the use of controls on capital inflows may be justified for a transitional period in the face of very strong inflows or as countries strengthen the institutional and regulatory environment in their domestic financial systems. In other words, capital controls could be countenanced as prudential measures - often second-best prudential measures, but nevertheless tolerable.

Still, the main emphasis of the report was not on controls. Rather it was on developing a proper risk management philosophy. Borrowing countries need to have their eyes open to the risks and
exposures created by capital inflows, that is on a proper risk management strategy for foreign currency and liquidity risks. Particular attention was paid to risk management by banks. Shortcomings in this area have made several recent crises much worse.

How should these shortcomings be addressed? One answer could be by fuller disclosure. As financial markets develop, disclosure becomes more necessary, and developing countries have much progress to make in this area. The present trend of supervisory oversight in countries with sophisticated financial institutions and deep financial markets is to rely more on banks' own - often more complex - risk management procedures. In this world, the supervisors' role is to verify that well-based procedures are in place and to ensure that disclosure is such that the market can sanction excessive risk-taking.

An alternative answer is better enforcement of rules. Although simple supervisory rules or guidelines on particular exposures have fallen into disuse in many highly developed countries, they may still have a useful role to play in the conditions prevailing in many emerging markets. Borrowers in many rapidly developing countries will not have long established credit histories and this will make credit assessments more difficult. Borrowers in countries that have recently liberalised may not have learnt to deal with foreign exchange risks. The banks and their supervisors may well be inexperienced. In addition, the deep financial markets used for hedging risks in advanced countries may not be available in many emerging markets.

For these reasons, the Draghi Report argued that the liquidity and foreign exchange exposures of banks in some emerging markets could be subject to some explicit regulation. Most countries already have rules that limit banks' net foreign currency positions. But it is gross foreign currency positions that have often proved to be a problem in the past because banks use borrowing in foreign currency - from both foreign banks and domestic foreign currency deposits - to fund domestic loans. In such cases, the banks’ net foreign currency exposure may be small because domestic assets denominated in foreign currency ”balance” foreign liabilities. They nevertheless remain exposed to the credit risk that their borrowers’ will not be able to service foreign currency loans.

Among the more explicit regulations to limit liquidity and foreign exchange exposures, the Draghi Report listed the following possibilities:

- Minimum holdings of liquid foreign assets to cover liquidity risks arising from foreign currency liabilities. Requirements could be tiered so that lower liquidity ratios would apply to long-term foreign currency borrowings than to short-term borrowing.
- Reserve requirements, with or without remuneration, could be imposed to discourage foreign currency funding.
- Regulations could require banks to match maturities of foreign currency assets and liabilities. More stringent, minimum maturities could be imposed on foreign currency funding.
- Regulations could require banks to hedge their foreign currency risk exposure in transactions and to ensure that their borrowers hedge their exposure as a condition for obtaining loans from banks.
- To lower credit risk, foreign currency loans could be restricted to a fixed percentage of capital or banks could be required to hold more capital and/or loan-loss reserves against these loans.

The general point is that there is probably greater need for relatively simple prudential rules in the supervision of banks in countries that have recently been through a crisis (or are in the process of liberalisation). Where supervisory resources are limited in quality or in quantity, simple rules may be more practicable.

The idea of standards

This leads me to the second, more general, theme of international efforts to strengthen financial systems world-wide - the elaboration of global standards. This has been one of the most important activities of the FSF. The systematic development of comprehensive international regulatory standards is quite new, even if the need for standards has long been felt. For example, Ralph Bryant (1987) concluded in the mid-1980s that increased international financial integration made necessary
"... the development of some agreed principles that would foster less heterogeneity in national regulations and supervisory procedures. Such "world standard" principles need not imply uniformity in national policies. But they would constrain national behaviour more than the "anything goes" presumption that is now the formal state of affairs ..."

He also noted that formulating such standards would not be easy, writing "insisting that smaller countries conform to the existing standards of the most powerful nations has a political logic, but not one with appeal to those who must conform."

In addressing this, Bryant's words find strong echoes in the recent debate. I would like to discuss three strands of recent discussions. One major source of controversy has been the sheer number of standards, some rather voluminous. This is probably an inevitable drawback of the decentralised process: each group thinks its concerns are of prime importance and there is no obvious mechanism of setting priorities. Without priorities, there is a risk that the most important or urgent standards could be neglected.

To help set such priorities, the FSF has - with help from both its own membership and from emerging market representatives - narrowed the list down to 12 key standards. Still, more work needs to be done on examining which standards have proved to be most important in the past. There have been very few analytical attempts to establish how far falling short on such-and-such a standard makes a country more prone to financial crisis. Not easy, but it does need to be attempted. In practice, of course, countries will set their own priorities. The large number of standards actually creates some room to manoeuvre.

A second source of controversy is the membership of standard-setting bodies. Here there is a trade-off. A smaller, homogenous membership is more able to take effective decisions than a larger, more heterogeneous group. The Basel Committee is often cited as one small and effective group. However, exclusion does not usually win friends. Once again, however, this controversy has to some extent been defused by consultative mechanisms which bring in others. Both the Basel Committee and the FSF have developed such mechanisms and have involved the private sector in some aspects.

A third issue is whether standards should be differentiated or standardised. Countries at different stages of development need different standards. On the other hand, standards cannot be tailor-made for particular countries if they are to function in establishing internationally accepted norms. In practice, this issue is to some extent being resolved by writing standards in a sufficiently general way that they can be applicable to all, but at the same time working out more detailed guidelines that can be tailored to individual circumstances.

To summarise: many of the controversies about standards have proved to be rather less troublesome in practice than they are in theory. Perhaps this is because standards are not prescriptive cook-books. They reflect rather a frame of mind. One of the great achievements to date has been to develop a consistent, common language to debate several of the issues that must be faced in building a strong financial system. Not so long ago, for instance, emphasis on the need for liberalisation and for better governance mechanisms in the developing world evoked some form of blanket denial (Asian values, the need for public sector banks to promote development, vulnerability to foreign domination etc.) This has changed. Remember Keynes's characterisation of economics in the preface of the Cambridge Economics Handbooks series: "The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking, which helps its possessor to draw correct conclusions."

Standards should be viewed in the same light. Few are immediately applicable to policy without further specification that can take account of the particular context. The real controversies, however, concern the last four words of the quotation "... to draw correct conclusions." Who decides whether conclusions are "correct"? This is the nub of many disputes about the use of standards: who assesses how countries measure up against them?

**Can the market assess performance against the standards?**
One answer to this question is "the market", a neutral arbiter, at any rate one that plays down the political influence of the governments of large countries. Countries are already well aware of the need to please the market - "credibility" I mentioned earlier - so this does not imply such a radical change of attitude. There is no doubt that the market has very great potential in supporting better policies. However, three impediments stand in the way of the full realisation of this potential. One is the limited awareness of the standards exercise outside the official sector. The second is the lack of reliable information. The third is that many private sector profit calculations are not very sensitive to the achievement of standards. It is perhaps useful to reflect a little on these three impediments.

First, limited market familiarity with standards. In time, this may change. A major educational effort is indeed now underway to publicise the standards through outreach exercises, seminars and the like. There have been many proposals, including one to put standards in the syllabus of professional exams. Education is always of course a worthy objective. Yet the problem here may be deeper. It stems in part from the proliferation of official initiatives in the financial stability area in recent years. Even some in the official sector find it hard to understand how all the new initiatives fit together. Several groups were created in the past few years, but none has disappeared. It must be remembered that more complex official sector constructions run the risk of confusing the private sector. The result, however well intentioned the objective, can be less transparency about what the public sector really wants.

The second, and greater, problem is that there is as yet only partial and incomplete information on how far particular countries have implemented standards. Market assessment obviously cannot work without information. The IMF's Financial Sector Assessment Programme has been developed to assess vulnerabilities in the financial sector and to identify reform priorities. This important process is just beginning to take off. The publication of some detailed conclusions may in time give the market better information. There is of course a trade off between the confidentiality of official assessments (which can encourage frank discussions at least within the official sector) and the need for more disclosure. But the balance of opinion is shifting in favour of better disclosure. One sign of this is that most countries have chosen to publish the IMF-World Bank Reports on the Observance of Standards and Codes (ROSCs), which provide summary assessments across a range of areas. About 100 ROSCs are expected on an annual basis.

A third impediment is that many market participants may not see standards as immediately relevant for their particular investment decisions. Remember, for example, that the governments of command economies were able to borrow on international markets rather cheaply - because lenders saw in the tight control of foreign exchange some assurance that they would be repaid. Market participants may not fully appreciate that such views are often rather short-sighted... in fact, many command economies did default on their debts.

Self-assessment versus external assessment

The main implication of these considerations is that the official sector has a role in nurturing the market's potential to encourage countries to adhere to the new standards. Once governments and IFIs are involved, however awkward political problems become more explicit, rather than implicit as they are with market mechanisms.

The main debate about the role of the official sector has been between those who favour self-assessments and those who favour external assessments. The case for self-assessment is that only those on the ground are really able to judge what reforms can be achieved and how to achieve them. According to this view, standards act as guidelines. The case for external assessment on the other hand is that it is essential for credibility. No one believes your exam results if you mark your own paper.

There is no one, right answer to this issue. The practical way forward is surely to find mechanisms that combine the better features of both, while avoiding the worse. One is to foster kinder, gentler standards. There has been reduced emphasis on penalties contingent on external assessment. For example, earlier proposals to link some bank supervisory ratios or practices to a country's achievement of the IMF's Special Data Dissemination Standard (SDDS) have been abandoned. And it is now more generally recognised that assessment of compliance is bound to be qualitative in nature.
Secondly, assessment should focus more on progress and not success or failure. Allowances could, and should, be made for the country's starting position.

A third development could be that self-assessments could be given greater credibility if subject to periodic external checks. Such checking could take the form of the national authorities setting out in advance certain measurable objectives (eg about the quality or timeliness of banks' accounting statements). They would in effect decide the priorities. But they would also agree to subject themselves to some external assessment. In this view, an external assessment conducted closely in conjunction with the national authorities can bring benefits to a country. Carrot rather than stick.

The recent experiences of the Basel Committee with their Core Principles of Banking Supervision throw some light on how the thorny question of how self versus external assessment can be side-stepped. The principles themselves were set out in very general terms in 1997. A major collaborative effort with supervisors to address implementation issues then got underway. A methodology of assessment was developed and tested in the field. This methodology can be used equally for self-assessment or for assessment by the IMF or the World Bank. The objective of these exercises was to see how implementation could be improved and consider whether the principles needed to be revised in the light of these practical experiences.

No one has a monopoly of wisdom. There was an inevitable trial-and-error element about this . . . a willingness to learn from experience. Such a process does much to ensure high quality standards. It also helps local supervisors persuade their political authorities of the need for reforms. This is very important. If they are to be effective, standards must be those that local supervisors feel are worthwhile and relevant in their particular situation and they must be standards that make sense to the international community of supervisors. It is impossible to think that any global standard setter would have done a better job than building on the expertise of the Basel Committee.

A final point is that putting in place good supervision is very resource intensive. I would like to conclude by saying that it is very important for supervisory authorities in the developed countries to be generous in the support they offer. Where possible knowledge and experience needs to be pooled. As you may know, the FSF has sponsored the creation of a global directory of training opportunities that provides online information about the courses available through relevant bodies to enhance the quality of financial oversight. The Financial Stability Institute, set up a couple of years ago by the BIS and the Basel Committee is helping senior supervisors to learn from each other. It has put together an impressive programme of conferences, seminars etc. to help bring supervisors world-wide up-to-date with the latest developments in supervision and in financial markets.

**Conclusion**

Let me finish by very briefly summarising.

1. The search for an optimal financial architecture is probably not very useful. Pragmatically speaking, several initiatives are taking shape, and in this the FSF is very important.
2. Capital flows can still create problems. Financial institutions in developing countries need to pay more attention to liquidity and foreign exchange risks. To help them do this, supervisors need to rely on more simple prudential rules than has become the case in advanced industrial countries. Is enough being done to develop such approaches?
3. The development of standards has raised many sensitivities. I have suggested that many of the dilemmas which seem so intractable in theory have been less troublesome in practice.
4. To come back to my simple fact about the 1990s. Can the 2000 decade be made one of strong growth without regular financial crises?

**Notes**

1. I am grateful to Kate Langdon, Allen Frankel, Karl Cordewener, Charles Freeland, Setsuya Sato and Gavin Bingham for helpful comments on this draft.
2. In what follows, I have drawn heavily on Green (2001), Icard (2000) and White (1999). An excellent account of the activities of various BIS groups is contained in Giovanoli (2000). The reflections of a former General Manager of the BIS are also to be recommended: see Lamfalussy (2000).


4. See www.fsforum.org/training/home/htm.

References


Langdon, Kate (2001). "Implementing international standards for stronger financial systems" BIS Quarterly Review. March 2001
