

The 3rd Annual PECC Finance Conference

***Institution-Building in a World of Free and Volatile Capital Flows:
PECC Perspectives***

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Session I

Issues and Challenges of the International Financial Architecture
from the Asia-Pacific Perspective

**Crisis Prevention: Domestic Policy Framework
and International Financial Architecture**

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Crisis Prevention: Domestic Policy Framework and International Financial Architecture

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Introduction

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- The benefits of being increasingly more integrated, certainly exceed the costs.
- However, a more globalized economy (trade and finance) may have higher exposure to external shocks.
- Factors to be considered, among others:
 - Volatility of capital flows
 - Financial contagion
 - Trade - world economic cycle
 - Commodity prices

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Introduction

- Capital flows allow the financing of additional investment at a lower cost; i.e., the attainment of higher growth rates.
- Capital flows may also facilitate the transfer of new technologies and ease access to foreign export markets.
- They may also increase the competitiveness and foster the development of domestic capital markets.
- Allow consumption smoothing.

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Introduction

- But capital flows can also cause trouble:
 - Overheating (large CAD and/or surge in prices);
 - Asset price bubbles;
 - Lead to excessive risk taking in the financial sector (over lending to risky sectors and debt overhang in the private & public sector).
- And since capital flows are highly volatile, the recipient country becomes prone to suffer from contagion and herd behavior.

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Introduction

- How to confront external shocks?
- Focus in crisis prevention.
- Dimensions to be considered:
 - Conform an adequate domestic policy framework
 - Strong international financial architecture
- Future challenges:
 - Macroeconomic Hedging

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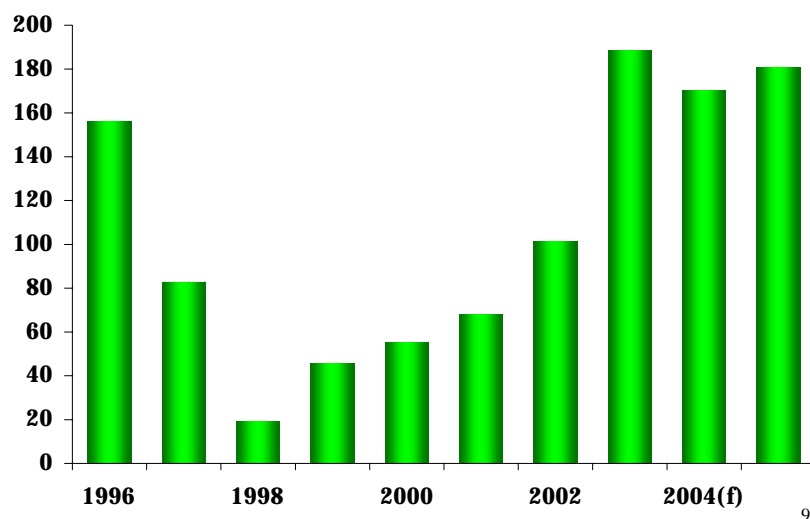
How to Manage Capital Flows

How to Manage Capital Flows

- The challenge is how to take advantage of the benefits of capital inflows but, at the same time, limit potential risks.
- Costs associated to crises are high. Factors behind them are associated to liquidity constraints and not long-term solvency problems.

Net Capital Flows to Emerging Markets

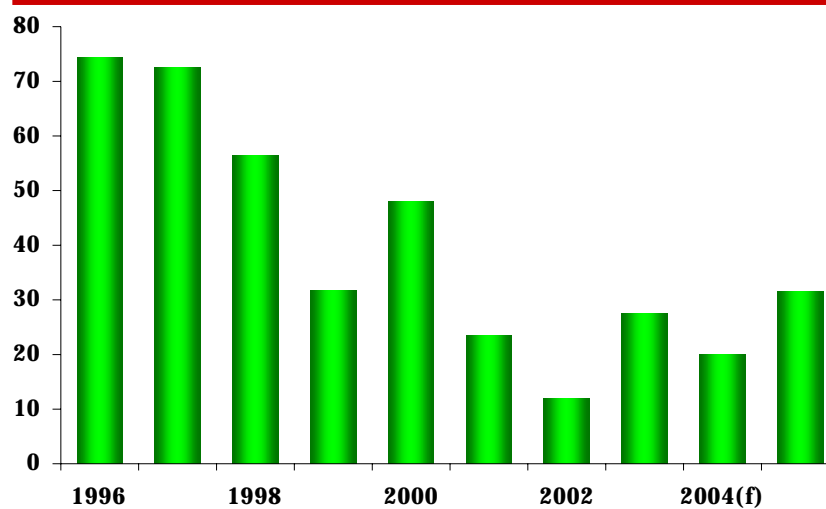
(US\$, bn; Source: IFS)



* Includes: net private flows, net resident lending, errors & omissions

Net Capital Flows to Latin America

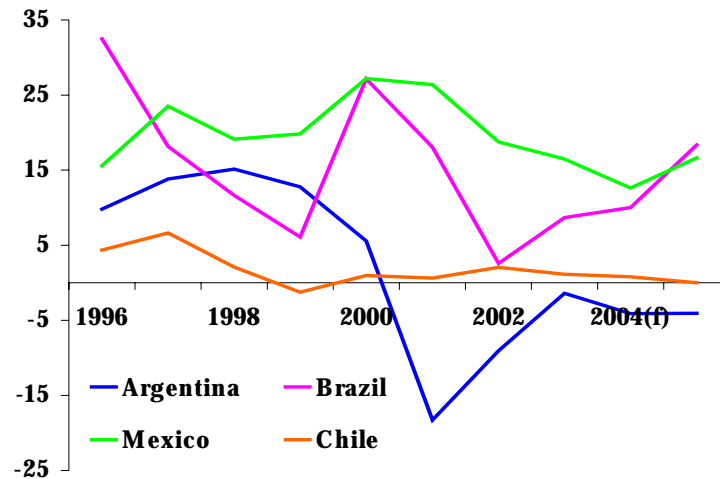
(US\$, bn; Source: IFS)



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Net Capital Flows to Latin America

(US\$, bn; Source: IFS)



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How to Manage Capital Flows

- Capital mobility amplifies the effects of domestic inconsistencies or distortions.
 - Unsustainable fixed exchange rates
 - Excessive risks taking in the financial sector
 - Excessive indebtedness of the public sector.
- Supply of international capital flows is in itself volatile, and also sensitive to contagion and herd behavior.

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How to Manage Capital Flows

- The first line of defense comprises:
 - Sound macro policies –with no inconsistencies among them– supported by robust institutions;
 - Strong financial sector supported by adequate supervision and market discipline;
 - Deep financial markets capable of allocating and diversifying risks effectively.
- Complementary dimension: international financial architecture.

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Domestic Policy Framework

Policy Framework

- To open the Capital Account successfully, countries require building a sound policy framework and developing strong institutions:
 - Establish a solid banking system;
 - Attain and maintain fiscal solvency;
 - Achieve an adequate level of trade diversification;
 - Invest in developing a credible monetary policy framework;
 - Set a credible and sustainable exchange rate regime supported by an adequate level of reserves.

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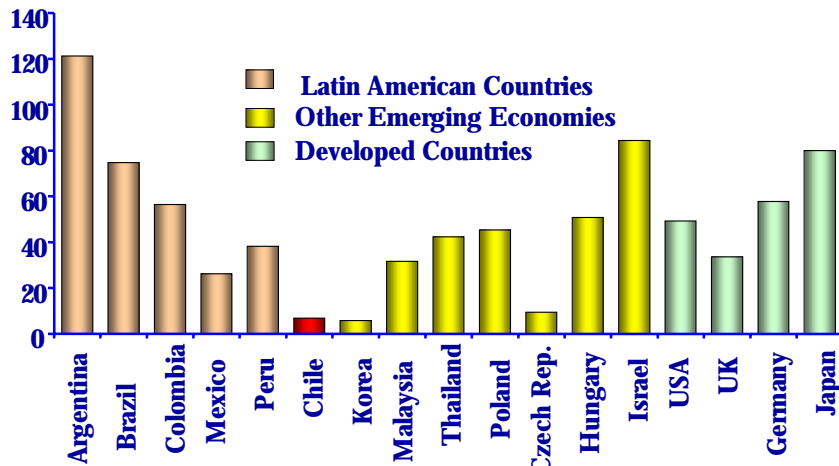
Policy Framework

- Such policy and institutional framework avoids inconsistencies between foreign exchange and monetary policy, and contains risk taking in both the private and the public sector.
- It is worth noting that credibility regarding the sustainability of policies gives more room to maneuver in the short run.
- And more room to maneuver reduces the costs of adjustments in case of adverse shocks.

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Public Debt 2003

% GDP (Source: DB, IMF)

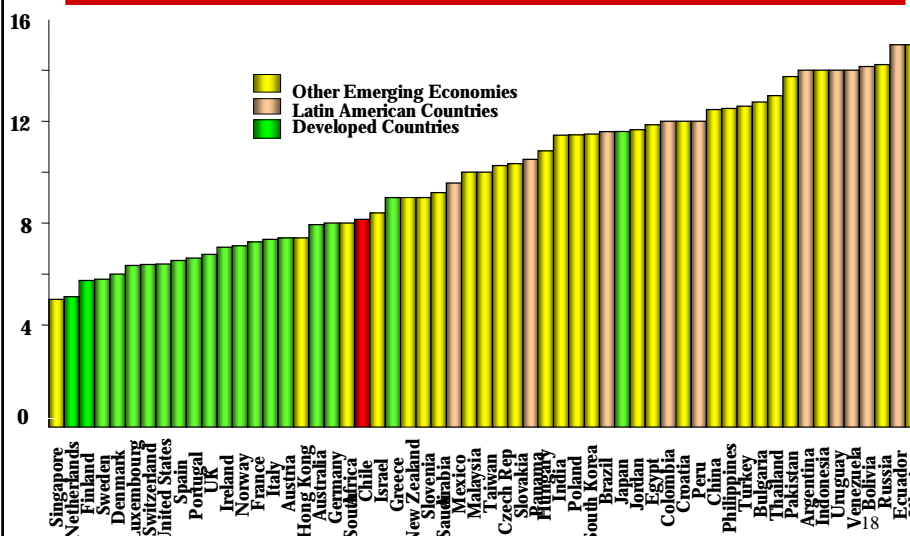


(1) Net central government debt (excludes reserves, debt from the central bank and social security trust funds)

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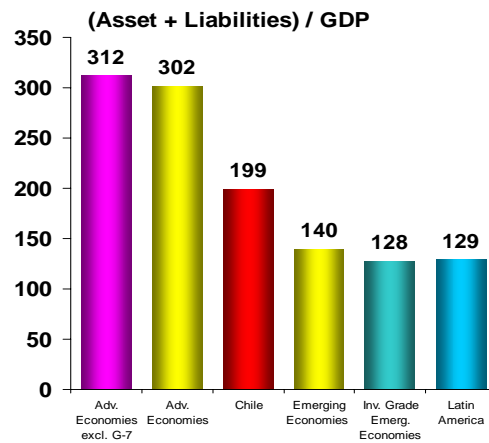
Ranking of Banking Sector Strength

(Source: Moody's, February 2004)



Financial Integration

- Financial integration is measured as foreign assets plus external liabilities as a proportion of GDP.
- Develop countries exhibit higher financial integration.
- Empirical evidence shows that financial strength increases with integration.



Source: IMF and Central Bank of Chile

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International Financial Architecture

International Financial Architecture

- Certainly, healthy domestic policies should be complemented with progress in strengthening the international financial architecture
- Dimensions to be analyzed:
 - Crisis prevention
 - Crisis resolution
- But, considering high costs of crises and the fact that the main factors behind them are liquidity constraints and not long term solvency problems.
➡ focus on crisis prevention

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Crisis Prevention: Assessing Vulnerabilities

- A crucial element of crisis prevention is the assessment of vulnerability and risks
- Self-assessments and evaluations made by International Financial Institutions
 - Financial Stability Report (the Central Bank of Chile, July 2004)
 - IMF/World Bank surveillance: Article IV; Report on the Observance of Standards and Codes -ROSCs; FSAP; Special Data Dissemination Standards-SDDS.
 - Regional financial institutions provide a regional perspective.

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Crisis Prevention: Assessing Vulnerabilities

- Surveillance should also include technical assistance in order to adopt strong, credible, healthy and transparent policy frameworks.
- Develop strong and credible institutions.
rules, enforcement mechanisms, and organizations that shape the functioning of markets.
- Transparency and good practices.

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Crisis Prevention: Standard and Codes

- The development of codes involving good practices is central in crisis prevention.
 - SDDS - Data dissemination standards
 - Code of good practices on fiscal transparency
 - Transparency in monetary and financial policies
 - Banking and insurance supervision
 - Payment system
 - Corporate governance
 - Accounting standards
 - Standards on auditing

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Crisis Prevention: Standard and Codes

- Open participation in the process of formulating standards has proven to be important.
 - Countries in different stages of development can point out which standards are the most relevant to them
 - Sense of ownership, which facilitates their promotion and implementation at home.

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Crisis Prevention: Financing Facilities

- Credit Contingency Line, CCL, promoted by the IMF, did not have the acceptance expected.
Main reasons:
 - Signaling problems
 - High cost
 - Low flexibility
 - Existence of alternative facilities
- However financing facilities that can help prevent balance of payment crises are needed.

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Crisis Prevention: Financing Facilities

- Then, we must define financing facilities, which need to be flexible in terms of timing and amounts available.
- In addition, flexible Credit Lines must favor countries that have adopted healthy policies.
- Limit moral hazard problems.

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Crisis Resolution: CACs

- Crisis will inevitably occur. The current process for debt restructuring takes longer, is more damaging to the country and less predictable than it should be.
- The inclusion by an increasing number of countries of CACs in new debt issues should be welcomed, specially when initiatives like the SDRM turned out to be difficult to implement.

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Crisis Resolution: CACs

- We are in a transition period and not all bonds include CACs. Thus, countries might still have difficulties in restructuring their debt in case of crisis.
- Aggregation Problems. In case of an eventual necessity to restructure the debt, persist the problem of aggregation.
- Indeed, we could have the coexistence of diverse objectives, defined under different jurisdictions and instruments, including bank credits or commercial credits.

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Crisis Resolution

- Official external financing should be available in case of crisis. Then, to assure success in reforms that must accompany a restructuring process.
- IMF exceptional access to resources should be complemented with funds from other official bilateral & multilateral sources.

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Role of Private Sector

- Private sector must be involved.
 - Has promoted the inclusion of CACs in new debt issuance
 - Elaboration of the voluntary Code of Conduct, is a step in the right direction.
 - Crisis Prevention Phase: Sound policies; adherence to Standards and Codes.
 - Crisis Management Phase. Economic reforms, debt restructure.

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Concluding Remarks

Concluding Remarks

- Crisis resolution has proven important , but we should change the debate towards crisis prevention.
- Crisis prevention starts at home, with a healthy, strong and credible macroeconomic and financial policy framework.
- The challenge is achieving political consensus to take necessary actions under favorable conditions to face adverse shocks well prepared.

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Concluding Remarks

- The international community can help by creating the right incentives for countries to advance by themselves in in the crisis prevention process.
- Participation of both private and public sector in the elaboration of a crisis prevention framework is crucial.
- Progress has been made after Asian crises, but a lot of work remains to be done.

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Concluding Remarks

- Future Challenges: Complementary measures may be focus on developing a strategy for macroeconomic hedging.
- For this purpose we may explore two complementary approaches:
 - Management of international reserves. In case of adverse shocks, portfolio return increases.
 - Insurance - commodity prices, economic cycle.

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Crisis Prevention: International Financial Architecture and Domestic Policies

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