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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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Introduction

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- The benefits of being increasingly more integrated, certainly exceed the costs.
- However, a more globalized economy (trade and finance) exhibit more 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, promoting 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 accelerate 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 challenge:
  - Macroeconomic Hedging

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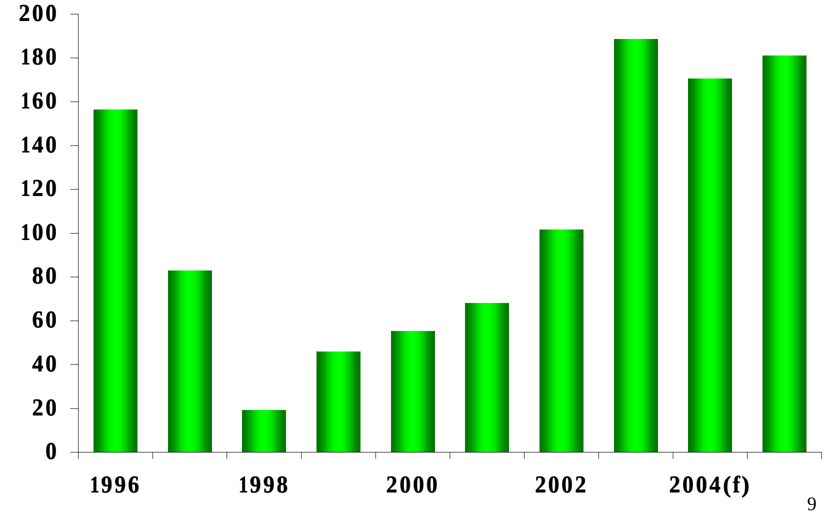
How to Manage Capital Flows

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)



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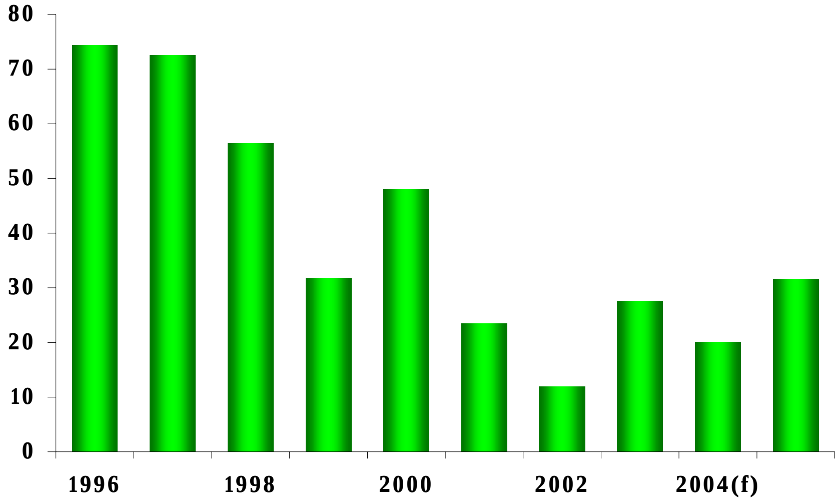
* Includes: net private flows, net resident lending, errors &omissions

Net Capital Flows to Latin America

(US$, bn; Source: IFS)



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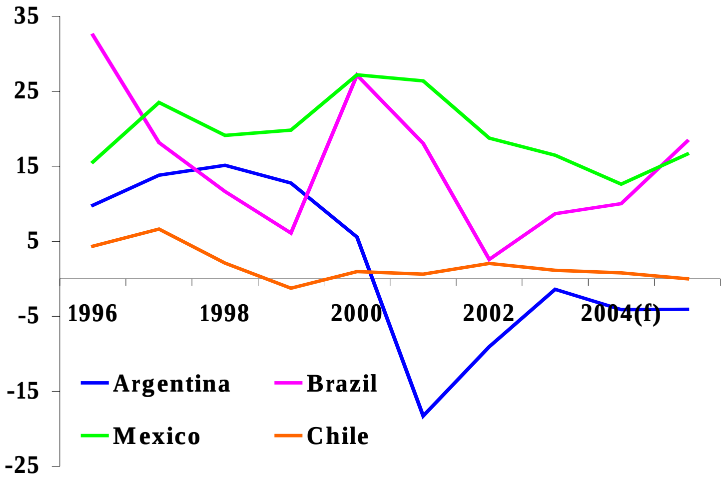
* Includes: net private flows, net resident lending, errors &omissions

Net Capital Flows to Latin America
(US$, bn; Source: IFS)



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

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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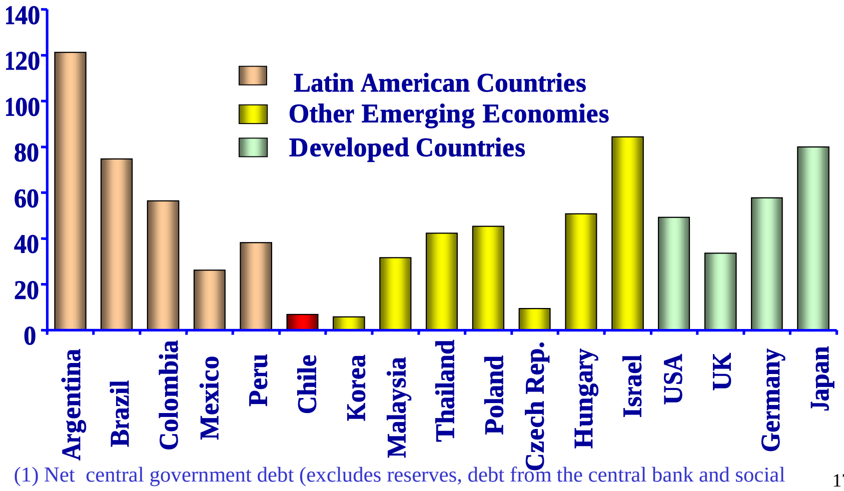
Public Debt 2003

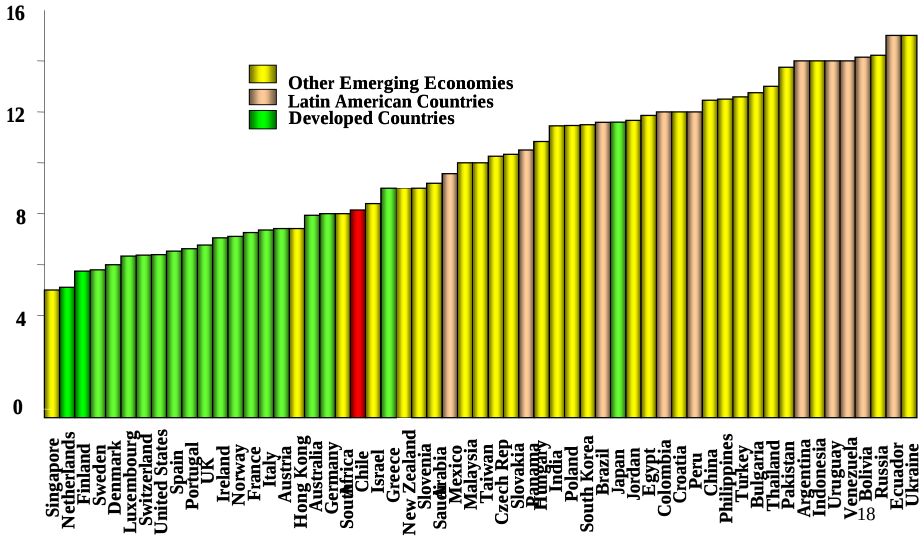
% GDP (Source: DB, IMF)



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

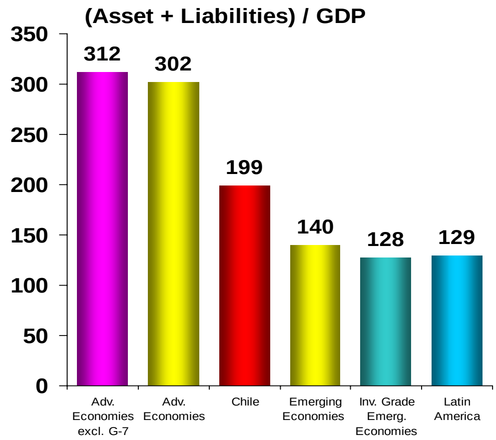
Ranking of Banking Sector Strength

(Source: Moody's, February 2004)



Financial Integration

- Financial integration is measured as foreign assets plus external liabilities as a proportion of GDP.
- Developed 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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Financial Integration

- Develop strong and credible institutions.

  Rules, enforcement mechanisms, and organizations that shape the functioning of markets.
- Transparency and good practices.

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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.

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Crisis Prevention
Assessing Vulnerabilities

- Regional financial institutions provide a regional perspective.
- Surveillance should also include technical assistance in order to adopt strong, credible, healthy and transpartent policy framework.

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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

- An economic crisis may 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

- 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.
- It is crucial 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 should increase.
  – Insurance - commodity prices, economic cycle.

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