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# THE EVOLUTION OF THE INTERNATIONAL FINANCIAL SYSTEM

Having participated over the last thirty years or so in the annual meetings of the International Monetary Fund and the World Bank, I thought it might be interesting, from a historical perspective, to roughly sketch the main themes of those meetings as they have evolved over the last decades.

As I recall, in the sixties and seventies, one used to stress :

- the dangers of inflation,
- together with the need to reduce fiscal deficits.

Then, in the eighties, as one had paid little attention to the recommendations on budgetary discipline, the emphasis shifted to the dangers of excessive public debt (domestic and external).

Today, the three dominant themes are :

- the excesses of private sector indebtedness,
- the need to rehabilitate and strengthen the banking systems notably in emerging countries,
- the importance of preventing and eventually dealing with financial crises in a more effective way.

Thus, there has been a shift from the combined concern : "Public budgets/Inflation" to a more systemic preoccupation : "How to avoid the excesses of indebtedness of the private sector and to improve on the functioning of financial institutions ?"

In a way, the themes of these annual meetings have become both privatized and globalized. This is because the world has, in fact, profoundly changed over that period.

I shall try to briefly outline some of the main traits of this evolution and finally suggest some thoughts for the future.

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## I. THE INTERNATIONAL FINANCIAL SYSTEM HAS DEEPLY CHANGED OVER THE LAST TWO DECADES :

In a very schematic way, one can say that the international financial system has evolved in four major stages over the last 150 years :

- until 1914, the gold standard was associated with essentially fixed exchange rates and with a great freedom of capital movements ;
- with the end of the gold standard in the early thirties, the system became compartimentalized : exchange rates were the object of discretionary, and often competitive, changes, and the use of capital controls became more and more generalized ;
- after the second world war, the Bretton Woods system combined stable exchange rates and capital controls ;
- since 1973 and the end of the gold/dollar convertibility, the system evolved towards flexible exchange rates and a general liberalization of capital movements.

How has the system evolved over the last two decades ?

The system has been strongly influenced by the positive results of anti-inflationary policies introduced in the eighties and by an unprecedented movement towards liberalization, but also by the lingering consequences of the macroeconomic mistakes of the sixties and seventies.

1. Anti-inflationary policies have made a great impact.

   These policies have had fundamental consequences on the financial system and on behavior. They have put an end to “monetary illusion” and to the perversions of negative real interest rates which were so common in the seventies, and which exerted such a toll on the allocation of resources.

2. The second factor of transformation has been financial deregulation, liberalization of capital movements and the elimination of exchange controls.

   One has moved from a compartmentalized world where capital movements basically “accompanied” physical flows of goods and

services, to an open world where capital movements dominate the financial markets by their size and their speed.

The revolution in information technology and in communications has enormously amplified these changes.

3. But the macroeconomic imbalances of the sixties and seventies continue, through the size of public indebtedness, to influence the reality of today.

Budgetary deficits of the past decades have accumulated in major public debt positions.

In a world where inflation measured by prices of goods and services is contained, where capital movements are free, and where most savers can choose the currency of their investment, governments no longer have the freedom to settle their debts in a depreciated currency. States must pay positive real interest rates if they want to borrow. This new and hard reality has led most governments to reduce their fiscal deficits by containing the increases in public expenses, by intensifying fiscal pressure and by engaging in an unprecedented move towards privatization. The objective being, through the reduction of public deficits, to contain, and hopefully to reduce, the burden of the public debt on the economy.

Although this structural rehabilitation of public budgets is far from being completed -particularly in Latin America-, it is starting to show some results. A number of industrialized countries (with the exception of Japan) and of emerging countries have now reached a balanced position, and even a surplus in their primary budgets (without debt service payments). Thus, the primary budget position of European Union countries has gone from – 2,2 % of GDP in 1982, to + 5 % in 2000, a swing of more than 7 percentage points. For the United States, the swing has been of the same magnitude (from – 1,7 % to + 5,4 %) over the same period[1].

As a result, in countries where fiscal rehabilitation is not yet completed, budget policy is, for structural reasons, more constrained today than it was in the past, and is not as easily usable as a macroeconomic adjustment instrument. This puts more responsibilities on monetary policy.

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[1] Although we are presently witnessing a return to fiscal deficit in 2002 in the US and a weakening of some fiscal positions in the European Union (Germany, Portugal, Italy, France).

## II. THIS NEW SETTING –REDUCED INFLATION OF CURRENT GOODS AND SERVICES, FREEDOM OF CAPITAL MOVEMENTS AND REHABILITATION OF PUBLIC BUDGETS- ENTAILS OR IS ACCOMPANIED BY A PROFOUND CHANGE IN THE FUNCTIONING OF THE INTERNATIONAL FINANCIAL SYSTEM :

1. Private capital flows are the main source of the world's financing.

In the seventies, net capital flows directed to emerging economies amounted to some 100 billion dollars per year, half of which was coming from official sources.

In 1996 (before the South East Asian crisis), the figures in real terms had tripled. The order of magnitude was 300 billion dollars. But, and this is perhaps more meaningful, almost all of those financial flows were coming from private sources (markets, credits, foreign direct investment). Since the 1997-98 crisis, commercial banks have sharply reduced their net annual flows (they are now negative by some 20 billion dollars) and the official flows are presently less than 20 billion dollars. Over the last two years, the total amount of net external financing is of the order of 150 billion dollars per year, nearly all of which coming from private foreign direct investment which has been the most stable and resilient element of all.

2. At the same time, it is the private sector which has become the central player on the macroeconomic scene. It is also the focal point of financial crises.

Whilst the share of public budgets in the GDP's of a number of countries is declining, it is notable that growing current account imbalances are essentially caused by the private sector. The "twin deficits" of the past have been replaced by private deficits. This was particularly clear in South East Asia. For example, the budgets of Indonesia, South Korea and Thailand registered substantial surpluses in the years 1995-96. But those surpluses came with significant current account deficits. It is the financing of those deficits, through an explosion of shorter and shorter external debt, which has triggered the bubbles in asset prices and, eventually, the exchange crisis of 1997.

In other words, because of the excessive growth of credit over the past few years, one has observed a shift from the couple : "fiscal

deficits/inflation of current goods and services" to the couple : "insufficient private savings/asset price inflation".

This is a fundamental change in the macroeconomic setting. This change puts more burden on monetary policy and, in particular, on the control of the growth of credit.

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## III. THIS SITUATION HAS SEVERAL CONSEQUENCES FOR THE FUNCTIONING AND THE SURVEILLANCE OF THE INTERNATIONAL MONETARY SYSTEM :

### 1. The banking systems must be rehabilitated, strengthened and better equipped to handle the new risks.

In the nineties, the acceleration of the private debt in emerging countries has, in many cases, led to speculative or unprofitable investments accompanied by unsustainable share and real estate prices.

It is not so much financial liberalization that is the problem, but the combination of capital liberalization and of vulnerable banking and financial systems incapable of dealing with risks -and in particular currency mismatches- in a professional, sound and non-political manner. That, added to deficiencies in macroeconomic and exchange rate policies, is what lies at the heart of emerging market crises.

An enormous and costly task has thus been taken up by national and multilateral monetary authorities, by regulators, by those in charge of banking surveillance, by rating agencies and, above all, by financial institutions themselves. Alongside the continuation of "fiscal mending", now is the time for rehabilitating, overseeing and recapitalizing financial institutions, in many countries. This will continue to exert a heavy toll on future growth. The experience of the last years shows that cleaning up overextended banks can be extremely costly : typically the burden can be of the order of more than 10 to 20 % of a given country's G.D.P..

### 2. Monetary policy is more and more complex.

Monetary policy must not only take into account the trends in monetary and credit aggregates, the movements in prices of current goods and services, but also asset prices and consequently their "wealth effects".

In a financial environment under constant change, where market instruments prevail over bank intermediation, where non-banks proliferate, where corporate defaults are dramatically increasing, and where financial innovation is creating everyday new forms of credits, credit surveillance is a major challenge. As J. Laurence Laughlin wrote in "Credit of the Nations", some eighty years ago : "inflation of money is the symptom, inflation of credit is the disease".

In a world where consumer psychology is in some countries, and in particular in the United States, so deeply dependent on the stock exchange, and where the value of collateral -which is by definition volatile- has a direct impact on the volume of credit and therefore on consumption, one understands that the task of monetary authorities is particularly difficult. It is all the more so in that inflation is getting very awkward to define. If limited to current goods and services, the definition loses much of its meaning in a world dominated by strong financial markets and where future prices (which can be defined as current cash prices for future consumption of services and are reflected in asset prices) are particularly relevant. But if extended to financial assets, the definition of inflation raises delicate problems in terms of concept, measurement, and interpretation.

How to assess the medium-term profitability of a company and its relationship to the value of its shares ? Is profitability reduced in accounting terms because information technology investment costs are immediately included in current expenses as they arise? Is it, on the contrary, artificially increased by the accounting methods adopted for the pooling of interests and for stock options ? In the aftermath of the collapse of ENRON, should we not overhaul the accounting methods used by a number of corporations (consolidation rules, off-balance sheet transactions, securitization, abuse of special partnership vehicles, treating future -and therefore uncertain- incomes as actual earnings…) which have, too often, lead to illusory profits ? In a world where certain investors and analysts are counting on -I should say "demanding"-, each year, a return on equity of more than 15 %, share buybacks by companies can be a tempting way of increasing share values. But this can lead, as we have observed over the past years, to excessive indebtedness.

Those issues were not, a few years ago, usual concerns for monetary authorities.

3. Finally, exchange rate management is more and more uncertain.

The exchange rate is a result of the balance of payments flows and the reflection of market opinion as to the sustainability of current account financing.

It is, in a way, the “circuit-breaker” of the system. In a world where most balances of payments and currencies are still national, where prices of current goods and services are relatively rigid and where capital movements are powerful, free and volatile, the flexibility of that “circuit-breaker” appears indispensable.

However, this flexibility and volatility give rise to consequences which can be very detrimental to the economic and financial stability of individual countries. Large monetary entities are relatively better protected against these repercussions, especially when they are strongly integrated trade wise. It is the case of the United States and of the European Monetary Union.

But the problem is more acutely posed to medium size and small countries open on the rest of the world. Be they wise or not, they can be affected by market euphoria that can bring them at times significant inflows of capital. But they can, later on, -even if they are wise- be devastated by capital outflows, which can happen violently at any time following a political crisis, some bad news or a phenomenon of “regional contagion”. We have seen the outburst of such events over the last years.

## IV. AVENUES FOR THE FUTURE :

This leads me to deal with the role of the IMF in this more and more globalized environment.

1. Agreement is unanimous on the need to improve the "preventive" role of the IMF :

Several analysts have argued that some of the recent financial crises -especially the 1997 South-East Asian crisis, the 1998 Russian one and the present Argentine meltdown- could have been, if not prevented but at least mitigated, if the proper warning signals and "adjustment pressure" had been provided early enough by the IMF and by those who are in charge of assessing the economic performance of emerging countries. In particular, it has been observed that not

enough attention had been focused at the time on the mounting indebtedness of the private or public sector, on its maturity and currency structure.

However, for such early warning indications to be provided in time, there is a need in the emerging countries for reliable, timely and transparent data. Hence the efforts by the IFIs to provide assistance to countries on data collection and reporting. Hence the encouragement provided by the IMF to member countries to publish article IV reports on their economies. Hence the incentives provided to emerging countries to adhere to the Fund's programme of "special data dissemination standards" that is intended to provide the market timely and homogeneous economic and financial data. Hence the regular quarterly publication by the IMF of the "Emerging Market Financing" reports. Hence the encouragement to emerging markets to engage in regular meetings and "road shows" with private investors. Hence the collaboration between the IMF and the World Bank to strengthen banking systems, risk management and surveillance functions in LDC's. Hence the need to publish on a regular basis the currency structure of bank loans. And I could go on and on….

But, most important, even if the data are right and timely, there is a need for the political authorities of the debtor country to be willing to adjust early enough and whenever necessary to take measures to reform. That is, without doubt, the most difficult and essential prerequisite for a successful preventive policy.

2. <u>But disagreements persist on the future role of the IMF :</u>

a) Here it might be useful to recall the essence of the <u>Meltzer Report</u> commissioned by the US Congress in 1998, and which provides one of the most critical analysis on the role of the IMF.

Basically, the Report recommends :

. eliminating IMF lending to countries affected by long term problems. The IMF should not, in the view of the authors of the report, be involved in long-term development assistance (as in Africa) nor in structural transformation (as in the post-communist transition economies). Therefore the enhanced structural adjustment facility and the poverty reduction and growth facility should be eliminated ;

. limiting IMF's lending operations to the provision of short term liquidity to solvent member governments when financial markets close. The IMF would therefore play a role of "quasi-lender of last resort" for solvent emerging economies in crisis situations. Liquidity provided by the IMF would be short term, carry a penalty rate (i.e. above the borrowers recent

market rate) and be secured by a clear priority claim on the borrower's assets. There would be no need for detailed conditionality since countries eligible to the short term lending would have to be "financially sound".

b) What are the reactions to the Meltzer Report ?

I think one should distinguish two types of situations : helping countries on the road to balance of payments viability and handling financial crises.

. The Fund should continue to provide assistance to countries as long as they demonstrate that they are committed to adjustment :

There is obviously here a major weakness in the Meltzer Report. It is not because a country is facing structural problems (development wise or transition wise) that it should not be eligible to IMF balance of payment support.

Helping a developing -or emerging- country to reach balance of payments viability over the medium term is, on the contrary, one of the most important functions of the Brettons Woods institutions. There are, in the history of the IMF, a host of examples that show how the Fund can be effective in it's role of providing policy advice and helping the adjustment. Let me mention, in this respect, the remarkable achievements in terms of fiscal discipline and monetary stability that have been obtained in a number of Latin American, Asian, North African or Eastern European countries over the last two or three decades or so.

Of course, there have been relapses and slippages. But if you look at the overall picture on the long term horizon, there is no doubt that the macroeconomic setting of the developing world has become less chaotic, less inflationary, and more conducive to private investment than would have been the case had we not benefited from such an institution.

This process can, in the event, lead to a string of Fund supported programs. The important criterion, here, is to avoid situations where things continue to deteriorate and where IFIs only keep on lending to recoup what the countries owe them. But as long as commitments and tangible results are there, the role of the Fund (be it as a "precautionary" standstill provider) can be easily justified.

. In cases of financial crisis, the IMF should enhance its catalytic role vis a vis the private sector and provide clear leadership in terms of needed adjustment :

I must admit that I do not comprehend the logic of the Meltzer Report recommendations for the Fund's role in crises management.

Making the Fund the "quasi lender of last resort" seems to me a solution fraught with danger. The "moral hazard" objection should be taken seriously all the more so because it is often difficult to distinguish a liquidity crisis from a solvency one. Besides, the Fund has only limited resources and, by contrast to a "normal" lender of last resort (i.e. a Central Bank), has no ability to issue money.

And if one assumes that a solvent country loses market access (the only case where the Meltzer Report envisages a lending role by the IMF), one fails to understand how a "penalty" rate applied by the Fund so as to make its assistance more expensive than the most recent market rate obtained by the country in question (by definition, already significantly dissuasive since it would be a "pre-seizure" rate) could help the interested debtor when one thinks of the potential magnitude of present spreads in crises situations.

The fact of the matter is that, in a crisis situation, regaining market access requires combination of several "reassurance factors" :

- a program negotiated by the Fund with the debtor country (macroeconomic discipline is always at the heart of the process allowing a country to regain market access). Here, the Fund has a unique role to play, one that no other institution can taker over ;

- some financing provided by the IMF, but not necessarily in very large amounts (much depends on the balance of payments requirements, on market sentiment, and on the degree of involvement of the private sector in the problem).

Indeed it seems logical that the IMF should devote more attention and efforts to the private sector involvement (PSI) in debt crises management. In a world where most of the debt is incurred by and owed to the private sector, it is normal and healthy that private creditors be called upon at an early stage to discuss debt restructuring. I know that the problem is more complex than it was in the 80's (when banks were the main actors) but it remains that private creditors (be they banks or bondholders) can and should be involved in orderly solutions whenever that appears possible. I am not advocating a systematic set of rules leading to compulsory mechanisms and standstills. That is not what is required. But I have argued that the Fund should call on the private sector early in the day and share

with its representatives (through the IIF and bond holders associations or committees for instance) the rationale behind a Fund program for a particular country, the concept governing its balance of payments viability and the financial requirements that are needed (given the limits to "normal" access to IMF funds, limits that should be made public and observed, barring exceptional circumstances). If such a framework was truly discussed between the IMF and the creditors (as it was 20 years ago), it would be easier to address in an orderly fashion the issue of private sector involvement and to address it with a “voluntary” approach and with market related solutions (ex: incentives to participate could take the form of limited guarantees or credit enhancements). In order to facilitate negotiations between the debtor country and dispersed bond holders, it seems appropriate, as has been advocated by the G7, to introduce collective action clauses in bond contracts. But I would warn against putting too much focus on ambitious and heavyweight solutions (like the recent IMF proposal of a "statutory" international bankruptcy system) which would require profound legal changes and new legislation throughout the world. Such a lengthy process does not seem warranted given that once a reasonable restructuring has been agreed by the main "players" (banks and major groups of bond holders), the risk of litigation initiated by some individual recalcitrant creditors ("free riders") is, in fact, extremely limited as shown by the experience of the last ten years (and could be mitigated by collective action clauses).

The real challenge is to combine an agreed framework based on a Fund program with practical, market oriented, case by case solutions. Hopefully there are recent signs suggesting that the G7 (April 20, 2002 -"Action Plan"-) and that the IMF are moving in that direction.

3. <u>As far as the functioning of the international monetary system is concerned, exchange rate management is more and more challenging :</u>

. From a systemic point of view, let me say that, aside form multilateral surveillance -which has its limits- and barring any revival of the SDR (international liquidity creation in cases of global need) -which I presently see as very remote-, the Fund could play a major role in the structural stabilization of the exchange rate system <u>if</u> the main players (G 3) decided to coordinate their policies in a way conducive to more stability. But I do not see this as realistic under the present and foreseeable circumstances.

. Concerning emerging countries, I should like to stress the central and crucial challenge they are facing in our globalized and free capital world. In

some respects, small virtuous countries are the most affected. What are their options ? Imposing exchange controls ? In some cases they can be useful, although I would hesitate to recommend them as a general and effective solution. In any case, better prudential control on short-term indebtedness of banks and enterprises seems to me advisable in order to reduce "currency mismatches". But from the standpoint of the exchange rate regime, what should they be doing ? Should they be pegging more or less rigidly their currency to an external anchor ? Should they be adopting a Currency Board ? Should they be floating freely ? Or should they be joining with their major trading partners and neighbors and adhering to monetary unions ?

In other terms, emerging countries have difficult choices : either they float, which gives them some flexibility in handling their monetary policy but does not shield them completely from the real shocks entailed by excessive exchange rate volatility. Or they attempt to "manage" their exchange rate, which, in times of external pressures -which are bound to happen at some time- is an almost impossible task. Or they "dollarize" or adopt a completely fixed peg to another currency (for instance, through a Currency Board). In the latter case, experience shows that this can only work if :

- the anchor currency is well chosen in terms of its trade and financial relationship with the pegger ;
- the emerging country performs well in terms of macroeconomic and particularly fiscal management,
- the economy is sufficiently flexible (wage wise including the public sector) to adapt to unwarranted changes in the value of the peg.

We have seen, in the case of Argentina, that over the last four to five years, those conditions were not met. Under such circumstances, the IMF sizeable financial "package" was of little use, since large imbalances and deflationary forces were building up in the country.

George von Furstenberg[2] has argued that the monetary system "fails to serve the legitimate welfare of emerging markets countries where currency crises, asset price deflation and financial economic meltdown tend to coincide. One of the greatest current failings of the international financial institutions and of the G7 is their failure publicly to recognize the needless pain and suffering caused by small countries hanging on to a separate currency that is being eroded by market forces and to recommend multilateral alternatives".

So, what are the solutions ?

[2] "One Region One Money", Washington, September 29, 2001 (Fordham University New York).

First let me note that it has been established[3] that capital liberalization does not necessarily lead to instability. The most successful emerging countries in this regard -and there are quite a number- have been "those who have combined sustainable macroeconomic policies, systematic approach to safeguarding financial sector stability and an exchange rate consistent with the other macroeconomic policies".

I believe that countries with weaknesses in their macroeconomic, fiscal conditions and financial systems should rely more on floating exchange rates. In any case, they should try to mitigate the effects of excessive volatility through determined anti-inflationary policy (i.e. inflationary targeting) and prudential control on external indebtedness of domestic agents[4].

Those with stronger structural and macroeconomic environments who have enough labor market flexibility and who happen to have an intense trade and financial relationship with a large country or a monetary union should consider pegging their currency to such an external anchor. It is probably in that direction that, in the years to come, we will see the international monetary system evolve. Indeed, we already observe, for example, in Central and Eastern Europe, a number of countries converging towards the Euro which carries substantial advantages in terms of spreads and financial stability[5]

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To conclude, let me say that the international financial system will remain fragile and volatile as long as a number of economies are characterized by excessive credit, bad public finances, fragile financial institutions, weak private savings, unviable exchange rate systems and major imbalances in their current accounts. The prospects and modalities of the financing of these imbalances are uncertain and depend on market sentiment and the perception of the risks involved.

In other words, the way to a better future does not rely too much, in my view, on legalistic so called "architectural" changes regarding debt negotiations, but on the implementation of the classical and more fundamental notion of

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[3] Cf. "Capital account liberalization and financial sector stability", IMF, Occasional paper (Washington 2002).

[4] See Morris Goldstein : "Managed Floating Plus ", Institute for International Economics, Washington, DC, March 2002.

[5] George von Furstenberg goes as far as as saying :"The strength of trade and finance relations, say of countries in the vicinity of the United States or of the Euroland, makes the almost complete financial integration and interest rate convergence that is available upon formally adopting the US dollar or euro more attractive than staying in the halfway house of a "Currency Board".

“adjustment”. This notion -which remains the leitmotiv of thirty years of IMF annual meetings- will continue to be high on the agenda, even if the environment and the sources of imbalances have, as I have tried to show, profoundly changed over the years.

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