The role of regional and global institutions in crisis prevention and management

Panel discussion contribution by William R White, Economic Adviser, Bank for International Settlements, at a conference on 'The role of regional financial arrangements in crisis prevention and management: the experiences of Europe, Asia, Africa and Latin America', organised by the Forum on Debt and Development, Prague, 22 June 2001.

I seem to have different views about the role of exchange rates than some others at this meeting. If I heard Heiner Flassbeck right, he said that exchange rate changes are not a good instrument to solve real shocks. I am not sure that is true. A real shock has to be absorbed. The question at issue is whether letting the exchange rate move leads to a more satisfactory overall outcome in the process. Let me use an example drawn from my Canadian experience; namely, the effects of an increase in commodity prices and the terms of trade. The real effect is that the commodity-producing sector must gain at the expense of (say) manufacturing, but this can be done in either an inflationary or a non-inflationary way. In the former case the exchange rate is held constant. Rising profits in the commodity sector lead to higher wages that spread to manufacturing. This in turn leads that sector to try to raise prices to restore profit levels. In the latter case, in contrast, the exchange rate is allowed to strengthen. This reduces the prices of all tradable goods, again to the particular discomfort of the manufacturing sector.

My second point has to do with what Paul Jenkins just said about rescue packages in sovereign crises. I think one of the reasons why the crisis packages have been so big is that people have looked into the abyss of the market solution and have been unwilling to accept that outcome. They say, "No, that is just too painful. We can't do that. There is no way the private creditors and the debtors can sort it out." What is now being suggested as an alternative are means to make the market solution less disorderly and painful. Suggestions include some combination of better financial standards, Fund lending into arrears, and the incorporation of collective action clauses into both new and existing bond contracts. I think further work along these lines would be very useful.

I agree with Leslie Lipschitz that there has recently been a major change in the way the Fund seems to be looking at things. There is now a much greater appreciation of the possible dangers arising from international capital flows. However, I was a little disconcerted by the extent to which his comments seemed to focus on country-by-country problems and issues. Fortunately, near the end of his comments he did note that the problem of capital flows might not be country specific. Rather, there could be swings in confidence in international financial markets that could have repercussions everywhere. Moreover, a large number of countries could be affected simultaneously by shared shocks of other kinds; effects on international trade of sectoral difficulties (eg, IT), changes in world energy prices, profits earned by multinationals from global operations, and the simultaneous and instantaneous access to the same information globally. International financial institutions, including the BIS, must give higher priority to monitoring changing global vulnerabilities and exposures of this sort.

As far as the BIS is concerned, let me go back to the role of regional and global institutions in crisis prevention and management. Let me be very clear about what the BIS is not. It is not an agency that tells people and countries what to do. Rather, It is a cooperative agency. We exist primarily to bring people together in order to talk about the issues of monetary stability and financial stability. We wish to encourage the sharing of understanding and to discuss what can practically be done to address shared problems. The networks established through this cooperative process seem to us to be very important. The fact that everyone knows each other, that they share many similar values, and that they at least understand others' views about economic processes is helpful for both crisis prevention and crisis management. As well, without calling into question the primacy of our client's interests, we at the BIS also try to develop new ideas and to disseminate them. For example, as noted below, over the last few years we have been doing a lot of work on the possible procyclicality of liberalised financial systems and how such tendencies might be reconciled with other more desirable attributes of such systems.

Crisis prevention

We at the BIS tend to think financial crises have become more common as the system has become more liberalized. In effect, we have moved back to a world similar to that which prevailed before World War 1 when commerce was global, capital flows were unrestricted and a high degree of economic volatility was the norm. The question that then arises is what might be done about this, using public policy or the influence of the public sector.

There are three different platforms at the BIS for addressing these problems, all using a cooperative approach. First, we have situated at the BIS groups like the Basel Committee that bring together national experts concerned about the health of financial institutions. The recent work of the Basel Committee, particularly on the Core Principles of Banking Supervision and on the New Basel Accord, needs no further elaboration here. Second, the Committee on the Global Financial System (CGFS) is another Basel-based committee, again made up of national experts, which worries about developments in financial markets. About two years ago the CGFS received a mandate from the G10 Governors to start looking at financial vulnerabilities in a much more serious way. So now, in preparation for CGFS meetings, the staff of the BIS provides up to date statistics and analyses of market risks, credit risks and liquidity risks for financial markets in both the industrial and emerging market economies. The third platform supporting the international financial system is the infrastructure. Here, the Committee on Payments and Settlements Systems is playing a big role by helping to develop global standards.

With respect to all three platforms, an important task is motivating people in different countries to actually implement the international standards that will make their domestic financial systems more robust. In this endeavour, the World Bank and the IMF are playing a very useful role. Broadly put, reliance is being put on the three incentive systems, or "pillars" that underlie the new Basel Capital Accord. First, people must be convinced it is in their own best interests to pursue reforms. Second, oversight from the official community and peer pressure can also play a useful role. Finally, market discipline and the rating agencies can also give some impetus for countries to do the right thing.

At this conference, we have concentrated on the issue of crisis prevention at the regional level. One problem with this approach, in so far as the BIS is concerned, is that we have been working hard in recent years to become an institution with global reach rather than one which is primarily regional (European). In fact, we have made welcome progress over the last five or six years even if there is still much to be done. One thing to note is that, unlike the Fund, the BIS is not an organisation with universal membership. Rather, we can allow selective membership and, indeed, have done so by offering shareholder status to only some of the more important emerging market countries. We want global reach and global input to our discussions, but the issue is how meetings and discussions at the BIS can nevertheless be kept small enough to be efficient.

Of course, this approach still leaves us with an inclusion problem that we all recognize. One way we are trying to deal with this is by using cooperation with regional central banks more effectively than we have done in the past. We have opened a regional office in Hong Kong, and are planning to open one in Mexico City. This will facilitate direct contact between the BIS and regional central banks. The other thing we are trying to do is to interact more with existing groups whose purpose is to promote central bank cooperation in particular regions. In Latin America, the principal such group is the Centro de Estudios Monetarios Latinoamericanos (CEMLA). However, Asia (and to a lesser extent Africa) presents something of a political problem for us because of the multiplicity of regional central banking groups to which Amar and others alluded this morning. Given certain rivalries, the issue of who to cooperate with takes on some importance. Nevertheless, we are proceeding as best we can by dealing with all initiatives on the basis of their individual merits, and by trying to build on the strengths of the different groups as we see them.

Crisis management

Crisis management is essentially the Fund's business. The principal way the BIS was drawn into it in the past was through so called "bridge loans". These occurred when a country was expected to receive a drawing from the IMF, but there would be a technical delay before the money was actually disbursed. In such cases, the BIS would lend the money up front, subject to a takeout by the G10 central banks (most of whom would be indemnified by their Treasuries). In recent years, as the Fund's disbursement process has improved, there has been much less need for this. In the past, it was also the case that some loans were made primarily for cosmetic purposes. There is now a greater understanding that such loans often offer no material advantage and can even be counterproductive.

Nevertheless, the practical experience that the BIS has accumulated over the years might still allow it to play a useful role in assisting initiatives to raise foreign exchange reserves in support of chosen exchange rate regimes. One possibility in this area would be support for regional initiatives like the Chiang Mai and Asean-plus-Three arrangements. Another would be attempts to raise funds in addition to IMF lines. Consider the case of Korea in 1998, where the US Treasury tried to arrange such support bilaterally from many countries. These efforts did not succeed, in part because each participant country had grounds for concern that other countries were negotiating better deals than they were. Demanding, in the middle of a crisis, that the troubled country negotiate simultaneously with a very large number of counterparties was never a very practical proposition. An alternative might have been to use the multilateral templates and legal documents developed by the BIS. This would have ensured fair and transparent treatment of all those involved, and thus facilitated negotiations. This was the outcome when the BIS helped arrange multilateral support for Brazil in 1998. A further role for the BIS might be to provide protection, given its immunities, to the foreign exchange reserves of sovereigns in the midst of a liquidity crisis. Akin to the need for ongoing financing subject to Chapter 11 in the United States, this might be a further small contribution to improvements in how such sovereign liquidity crises are currently managed.