The Future of International Financial System and Its Implications for Korea*

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I would like to speak about the future of the international financial system and in so doing, I plan to draw heavily on the recent Council on Foreign Relations Task Force Report. The taskforce was put together at the suggestion of President Clinton, who thought it would be a good idea to see if a group of prominent private sector Americans might be able to contribute something to the international financial architecture debate. It was made up of a diverse group of economists, financial market participants, business leaders, regional and political experts and former Congressmen. Former U.S. cabinet members, Pete Peterson and Carla Hills acted as the co-chairs. Given the quality of the group, it was a great honor for me personally to serve as the project director and the author of the report.

There are two themes in the report that merit emphasis right up front: responsibility and incentives. We argue that the primary responsibility for improved crisis prevention and resolution in emerging economies should be put back where it belongs, namely on emerging economies themselves and on their private creditors that dominate today's international capital markets. But neither emerging market borrowers nor private creditors are likely to exercise that responsibility if the amounts of public money available for financial rescues, both at the national and international levels, are too large, and if the conditions for activating those rescues are not demanding enough. Turning to incentives, we will not make real traction on crisis prevention unless we change the behaviors of borrowers and lenders, and this will not be achieved if we do not improve incentives for implementing better risk-management.

Let me offer you a story about incentives and risk-management. It's about a man named Harvey and his parrot named Irving. Irving is capable of much more than just

* A presentation at IGE Distinguished Lecture Forum on March 28, 2000.

"Irving wants a cracker". He's capable of much more formidable tasks. Indeed after a period of some studying, Irving the parrot masters the complete works of William Shakespeare and can recite all the works in five languages. So, Harvey is very proud of Irving and wants to show him off, and maybe make a couple of bucks. So, he advertises that his parrot can recite the works of Shakespeare and the town's people, of course being cynical, makes wagers against Harvey and Irving. On the night of the performance, Irving does not say a word all night. Embarrassed Harvey makes apologies, loses most of his money and goes home. He comes home and is raving about how he can't understand why Irving didn't perform as he did the night before. To angry Harvey, Irving the parrot explains why he did this. Could Harvey imagine the amount of money they can win next year by making the same wager in this town?

That's incentive. If you don't change the incentives, you don't change the way people behave. This debate is not really about international financial architecture, it is about incentives for changing the way borrowers and lenders behave. In what follows, I am going to highlight five inter-related sources of vulnerability to financial crisis. After identifying what is broken in each of those areas, I am going to summarize the task force's recommendations for fixing them.

The first problem is the weak national banking and financial systems in emerging economies.

In the past 20 years, there have been 70 cases of banking problems in emerging economies that caused the entire banking system to become insolvent. The U.S. S&L crisis cost the U.S. taxpayers approximately 2-3% of U.S. GDP. In several of the Asian crisis countries, we're looking at costs of around 20-60% of GDP to rebuild damaged banking systems. Korea's is around 15%.

Bank lending standards in many emerging economies have been very lax. In the run up to the Asian crisis, a sizeable share of bank lending went into real-estate and equities, only to go sour when cyclical conditions later deteriorated and interest rates rose. Lending standards were also compromised by heavy government involvement and ownership of banking systems and high levels of connected lending. That, of course, was a problem in Korea. A weak accounting disclosure and legal framework usually added to problems. With several significant exceptions, bank capital was low relative to the riskiness of the operating environment.

In many countries, there were no well-developed debt markets. Thus, when the banking system crashed, there were few alternative sources of credit. Countries now have before them a comprehensive international banking standard on which to model the upgrading of banking supervision. International standards are now also available in other areas, including publication of economic and financial data, cross border listing of securities, etc. To make an impact on crisis prevention, countries have to implement and enforce the standards.

Their incentives to do so should operate by three channels. The first is the expected market payoffs. If markets can tell who is and who is not implementing the standards, then those countries that do implement them should benefit from a lower market cost of borrowing. The second channel is the IMF and the World Bank. Specifically, the IMF and the World Bank could give countries that implemented the standards a better insurance deal when they need loans. The third channel is by assigning risk-rates to various kinds of bank loans under international agreements for regulatory capital. Loans to countries implementing the standards could qualify for a preferred risk-rate. At the present, however, only partial, initial and tentative steps have been taken to make any of these incentive channels operational.

How could we strengthen the incentives? According to the taskforce, the IMF should relate the interest rates it charges member countries that borrow from the fund to the strength of the countries' crisis prevention efforts. For this purpose, crisis prevention efforts should be interpreted to mean sound macro policies, compliance with a set of international financial standards, maintenance of a viable currency regime, prudent debt management, and efforts to put into place various sources of liquidity support. The Fund should also make public both the standards report that assesses the country's progress and meeting standards, and its article for consultation report that assesses the country's overall economic policies and prospects.

The second problem is poor public and private debt management with inadequate liquidity defenses against shocks and premature financial liberalization.

At the heart of the Asian crisis, there was a large build-up of short-term unhedgy foreign currency debt by banks and their corporate customers. The trouble with the debt strategy that condones large liquidity, currency mismatches, and high leverage is that

any shock that significantly reduces cash flow or net worth and leaves creditors to lose confidence can upset the whole apple cart. And when there were plenty of negative shocks in Asia in 1986 and 1987, growth of merchandise exports slowed dramatically.

There is also the long-standing problem of volatility of private capital flows into emerging economies. Net private capital flows to emerging economies declined from about $250 billion in 1996-1997 to about $150 billion in 1998. For the Asian crisis countries, the fall was sharper yet. The same kind of volatility is evident in the prices in terms of financing. If you plot out either the volume of private capital flows or the spreads on emerging market borrowing over the past 20 years on a graph, it looks like the electrocardiogram of a person with a very bad heart condition. Within this volatility of overall private capital flows, short-term flows provide a particular risk because the short maturity makes it easier for investors to run at the first hint of trouble.

During the Asian crisis, net flows of foreign direct investment to emerging economies actually increased slightly, whereas portfolio flows and bank loans plummeted. Concern over short-term flows has prompted some emerging economies to impose holding-period taxes on capital inflows. Chile's system, which utilizes an unremunerated reserve requirement at the Central Bank for inflows that stay less than a given time period, is the most well-known. Available evidence suggest that Chile's holding-period taxes have tilted the composition of capital flows into the desired direction toward longer-term flows, which are less-crisis prone. But, relatively few emerging economies now have such holding-period taxes in place.

Another problem is that the risk-rating system for commercial bank assets that was embedded in international agreements gave a relatively low risk rate to short-term claims on banks from many countries, thereby encouraging banks to engage in inter-bank lending. This bias has been reduced, but not eliminated in the proposed revision of Basel-Capital Accord.

It doesn't have to be this way. Emerging economies can lengthen the maturity stretch of their debt, build up their stock of reserves, make their banks subject to rigorous liquidity in reserve requirements, hedge currency and interest rate exposure, limit the share of new debt denominated in foreign currency, and arrange contingent credit lines from private banks.

But how can we strengthen the incentives to do so? The taskforce recommends that the IMF should not merely permit Chilean-type holding-period taxes on short-term inflows, but should advise all emerging economies with fragile domestic financial sectors to implement such measure. Where such taxes on inflows are applied, they should be transparent and non-discriminatory and should not impede the entry of foreign financial institutions into the financial services industry. In revising the Basel-Capital Accord, regulators should avoid waiting schemes that provide a lot of incentives for short-term flows or inter-bank lending.

The third problem is vulnerable currency regimes.

There are only two emerging economies with relatively open capital markets have had fixed rates for the last five years or longer: Hong Kong and Argentina. In the recent crisis, Thailand, Malaysia, the Philippines, Indonesia, Russia and Brazil have all been forced into regime of managed floating.

There are several sources of vulnerabilities associated with fixed currency regimes. Let me just mention two. One has more to do with politics than economics. If the market is not challenging the over-valued peg, there is no political support for devaluing. By the time the markets have begun to apply pressure or the problem becomes obvious, it's already too late. The second source of vulnerability is that there are strong limits to how long most emerging economies can keep interest rates very high in a currency defense. Vulnerability will be very high if the banking system is fragile, if the corporate sector has high debt to equity, and if the economy is experiencing slow growth or outright recession. But many emerging economies will be tempted to try to defend an over-valued fixed rate, if they can get a lot of money from the IMF or the G7 to do so. The Brazilian crisis was a case in point.

Well, what should we do? The answer is, just say no. The IMF should counsel against adopting a currency regime based on the adjustable peg and should place strict limits on the financial support, if it stands to defend that kind of regime. In most circumstances, the IMF should encourage emerging economies to adopt and maintain a currency regime of managed floating, with currency boards and a single currency reserved for more unusual circumstances.

The fourth problem is the so-called "moral hazard" problem that blunts market

discipline.

If market participants expect an official bailout of troubled borrowers, then private creditors will have little incentive to monitor the condition of borrowers. The international community committed about $190 billion, of which about one-third was disbursed in the rescue packages for Thailand, Indonesia, Korea, Russia and Brazil. The Miyazawa Plan added about $30 billion more. The Thai and Korean authorities issued broad guarantee announcements for bank depositors and creditors shortly after the outbreak of the crisis. Indeed, equity holders and to the lesser extent, bond-holders experienced significant losses in the Asian crisis and banks were hard-hit during the Russian crisis. We also need to keep in mind that moral hazard is a problem with all insurance arrangements. This does not mean that we should not have insurance, but that there is a need to limit the amount of payment or price of the insurance appropriately. A second caveat is that by providing emergency assistance to a liquid borrower and preventing a costly default and its spillover, a “lender of last resort” can serve a useful function for the economy as a whole.

Still, there are three points of moral hazard that deserve emphasis. First, it is not convincing to argue that a repetition is unlikely just because the experience of the Asian crisis has been so costly for borrowers. That’s the same argument that was made aftermath of the Mexican crisis, and we had the Asian crisis two years later. Second, default to rescheduling should not be considered a largely unanticipated event when creditors are sometimes receiving interest rates on emerging market securities anywhere from 300 to 5,000 basis points above U.S. treasury’s. What are you getting the high interest rates for? The market system does not say you should get two scoops for assuming risk. One scoop in the form of a higher risk premium when you purchase the debt and the second scoop in the form of an official bailout, if things work-out badly. Third, if you want to see what happens when moral hazard gets very large, you only need to look to private capital flows to Russia and the Ukraine in the run-up to the crisis. Here, private creditors continue to pour lots of money into these economies because they assumed that given Russia and Ukraine’s geopolitical importance, the G7 and the IMF would not allow them to devalue or default. Over the past two years, we have not made a lot of progress on the moral hazard issue. For example, we do not yet have a timetable for deposit insurance reform in most emerging economies, even though the major source of moral hazard occurs at the national level.

A second problem is that some IMF rescue packages have gone well beyond the Fund's normal lending limit. The normal lending limit for the Fund is 100%-300% of a country's quota in the Fund. The packages for Mexico, Thailand, Indonesia and Brazil had packages that were 500%-700% of their quotas, and for Korea, the package was 1900% of its quota. In thinking about the implications of smaller rescue packages, I would like to list a few points.

First, the packages should strictly adhere to normal access limits, which still permit Fund programs to reduce the recessionary impact of a crisis, to finance some smoothing in the foreign exchange market and to make a modest contribution toward the cost of banking reform and recapitalization. But, it would curtail the scope for supporting overvalued or fixed exchange rates and for bailing-out large uninsured private creditors.

Second, it is not obvious to us that there is a unique level of Fund financial support that is associated with regaining confidence in a crisis country. In recent experience, countries' conditions did not seem to stabilize right after the singing of a program. The return of confidence came later, when there was stronger evidence of both political leadership and concrete policy actions to address the underlying problems. Yes, smaller rescue packages would probably imply that the developing countries would face a somewhat higher cost of borrowing and smaller flow of finance in the future. But since spreads on emerging market borrowings have been too low and the flow of capital to them too high in much of the 1990s, some moderate move in the other direction would not be a bad thing.

Third, how do we tilt the incentives to reduce the moral hazard? At the international level, the IMF should make it known that it would provide emergency assistance only when there is good prospect of the recipient country achieving medium-term balance of payments and debt viability. If the country has an unsustainable debt profile, then the IMF should ask, as a condition for its support, that debtors engage in good-faith discussions with private creditors with the aim of reaching timely agreement on a more sustainable profile. No category of debt, not Euro bonds or Brady bonds, should be exempt.

Fourth, to increase the orderliness and timeliness of debt rescheduling, all countries should commit to including collective action clauses in their sovereign bond

contract. By all, I mean the U.S. as well. Such collective clauses make it harder and less profitable for a few rogue creditors to block a rescheduling that is in the wider interest.

The fifth and last problem deals with threat to the effectiveness of the IMF and the World Bank.

Ever since the Asian crisis broke out, there has been a barrage of criticism directed at the IMF. In the taskforces' view, a lot, but not all of that criticism have been misguided. As costly as the Asian crises have been, we probably would have seen deeper recessions, more competitive devaluations, more trade protectionisms, and far more human suffering had there been no financial support from the IMF. Here, we disagree sharply with the Meltzer Commission. We think the Fund and the Bank have made a positive contribution. However, this does not mean some reforms in the IMF are not needed. In particular, the IMF rescue packages have become too large and the IMF's mandate and conditionality have become too all-encompassant. The watchwords for the IMF lending should be "less will do more", while that for the IMF mandates should be "back to basics".

Well, how can we bring these desired changes into being? To reform the IMF lending practices, the IMF should adhere consistently to the normal access limits, that is, 100% of Fund quota on an annual basis and 300% cumulatively for country crisis. That is for crises that do not threat a functioning of the entire international monetary system.

In the unusual case where there appears to be a systemic crisis, the IMF should turn to systemic back-up facilities, either the existing arrangement to borrow or a newly-created contagion facility. The existing arrangement to borrow should be used when the country's problems are largely of its own making and when an IMF program is needed to correct them. The contagion facility would be used for cases of systemic contagion when the country is mainly a victim of a contagion. A new contagion facility should replace the contingency credit line and the supplementary reserve facility in the Fund. Activation of the contagion facility would require a super majority of the creditor countries contributing to it, to agree that it is a systemic crisis and that contagion facility would be funded by a one-time allocation of IMF special drawing rights. There would be an agreement that only developing countries could draw on the facility.

To reform the IMF's mandate and conditionality, the IMF should limit the scope its conditionality to monetary, fiscal, exchange rate, and financial sector policies. The World Bank should concentrate on longer term structural and social aspects of development. It should expand its work on safety nets, but should not be involved in crisis management, emergency lending, or macro-policy advice.

Well, you might think that this is pretty much what you have heard from the G7. Yes, there are some overlaps, but no, it's not the same set of recommendations. We take a tougher line on lender moral hazard and on private sector burden-sharing, attach a higher priority to refocusing the mandates of the Fund and the Bank, take a harder position on limiting IMF's support for adjustable peg regimes, prefer the IMF to be more explicit in identifying publicly which countries that are and are not meeting standards, take stronger a view on the need for the G7 countries, including the U.S. to lead the way on institutional changes in private capital markets, including the use of collective action clauses, and we favor a different design in funding mechanism for a contagion facility.

In the last week or so, another commission on the international financial architecture, the so-called "the Meltzer Commission" has issued its report. It is more radical in its recommendations than the CFR report. It has so far not met with bipartisan support.

My own view of the Meltzer Commission recommendations is that some of them are good and some are simplistic and counter-productive. I would not have been able to sign on to that report had I been a member. The report is useful in calling for smaller and more focused IMF, in trying to improve the incentives for upgrading financial systems in emerging economies, in seeking to get the IMF out of the poverty business, in counseling emerging economies to avoid adjustable peg regimes, and in recommending publication of IMF reports. These, I agree with, because they are also in the CFR report.

I think the Meltzer report is not sensible in trying to do away with IMF fiscal and monetary policy conditionality in favor of a few basic structural preconditions. Once you get into a crisis, you will not get out of it without doing something in monetary and fiscal policies, it is not enough to say you have free entry into banking. I think the report is also misguided in ruling-out any IMF support for countries that do not meet

structural membership conditions. In that case, Korea would not have been able to qualify for any IMF support. It is one thing to say packages are sometimes too large and that countries that behave better should get lower interest rates. It is another thing to say, if you do not meet any of the conditions, you will not get anything.

I think the report is also misguided in ignoring the merits of collective action clauses in sovereign bond contracts and not recommending holding taxes on capital inflows. And it is not good that the report largely ducks the issue of private creditor burden-sharing--that is a key issue in the creditor and borrowing countries.

Suppose the CFR recommendations were to come into being, how would they affect Korea? I see three effects. First, Korea would get more recognition and greater market payoff for the things it has been doing recently to reduce its crisis vulnerability, strengthening banking supervision in the financial sector and reducing currency and maturity mismatches. Second, because private creditors would know that they were more responsible for bearing the consequences of poor lending decisions, we should see less over-lending on the part of the banks in industrial countries. Third, if Korea has to go to the IMF in the future, the Fund's conditionality would be less intrusive and less wide-ranging, but the amount of financial support it could get would also likely to be smaller, unless there was a global crisis.

Question & Answer

Q: In the case of Korea, Korea did have a peg exchange rate system at the beginning of the crisis and the government was very leery about changing the system, so it went first with widening the bands, and eventually doing away with it. Despite its fears, once it did away with the peg, it seems to help calm down the situation quite a bit after a couple of days. I think that lends some support to your view on the need to advise countries not to peg interest rates. I have a question on the third recommendation about the burden-sharing and collective action clauses. Can you explain exactly how that would work and would private creditors be prohibited from lending without those clauses in them?

A: The purpose of collective action clauses is simply to make it easier to reschedule private debt when a majority of creditors want to do so and when it is in the debtors'

interest. To do so, you would simply have these clauses put in the new bond contracts. If there is a problem, then it will be a majority decision. Without it, it will be very difficult to reschedule because you can have private suits, which would trigger cross-default clauses.

Many of these collective action clauses are in bank loan agreements, but they are not in bond contracts. The importance of its presence is that bond financing has become much more important in the past 10 to 15 years in developing country financing. It was not seen as important in Asia in the past. However, it will be important in the future because if it becomes very difficult to reschedule when there is a problem, then your options are very limited, often ending up with either a very large package, full of moral hazard problems, or a very chaotic rescheduling. The difficulty is that it is almost like a prenuptial agreement: the signing party becomes suspicious once asked to put such clause in contract, causing the lenders to charge higher interest rates. So, the solution would be to include the clause in all bond contracts, but thus far, the G7, particularly the U.S., has refused. And so, not much progress has been made in that regard. However, I think it would be one of the institutional changes that would be helpful in the architecture.

Q: You mentioned that collective action clauses are included in many bank loan agreements. But in the case of Korea, I do not think the clauses were included during the financial crisis. Why was that?

A: That is right. You can always try to do it without the clauses. However, it is much harder to reschedule if a clause was not included in the contract to begin with. In some cases, it has been done without the clauses, but in many cases, it was almost impossible, such as in the Russian case.

Q: I think that the IMF can play a more important role in that regard because in the case of Korea, the U.S. Fed was actively involved. Maybe we should have IMF's functions revised so that it can play a role in rescheduling. What do you think of that?

A: Well, the IMF is an important player. What we recommend in this report is that if a decision has to be made to have a temporary payment standstill, the country should make that decision and the IMF should recognize it. The IMF should also take an activist's role in the sense that in very extreme cases, when it looks quite clearly that

without some major rescheduling, the IMF should insist that here be such agreement as a condition for its own support. This issue of standstill has come up and some thought that the IMF articles of agreement should be changed so that the Fund has the power to do this. Others have argued that this is too intrusive; there are a lot of legal issues. So, I agree that the Fund should be a major player in these issues.

Q: I was looking at the seventh recommendation regarding the verbal conference of finance ministers. It sounds like a global federal reserve board. What would be the constitution and representations? Would it be permanent?

A: Initially, it was not meant to have a permanent body, but many of the people on the taskforce felt that once the crisis was advance in its resolution, the problem of losing momentum would rise. So, the taskforce came up with a resolution to have a one-time special meeting to try to set timetables for doing some of these things and get the momentum going.

Q: Recently, the ASEAN, Chinese, Japanese and Korean government representatives agreed on studying the setup of Asian facilities to aid crisis-stricken countries in the future. I understand that the IMF opposed the idea when it popped up several years ago. Is there a conflict between the IMF and the newly established facilities for Asian member countries?

A: Well, we did talk about some regional arrangements in this report. You are right; the U.S. first opposed the Asian monetary idea, as did the IMF some years ago, when it was first brought up. I think the main issue is the conditionality. Would an Asian Monetary Fund have conflicting conditionality with the IMF? Obviously, there are a lot of financial resources in this region. If an Asian Monetary Fund were to advance funds with same conditionality as the IMF, there will be no problems. However, if it were to put forward a very different conditionality, then there is the potential for conflict because if you can get a lot of money in the region with less reforms or different reforms, then the IMF conditionality will become less effective. It all depends on whether you believe that the IMF conditionality is effective to begin with. If you are worried about moral hazard, let's just say that when a lot of money is involved, both lenders and borrowers should be more careful.

Q: What are the definition and scope of the new international architecture? Getting

consensus on direct regulations on HLI has been very difficult, especially with the objections of the U.S. What is your opinion on direct regulations on HLI? There are two rules in private participation in crisis resolution: rule base and case-by-case. Which do you think is better?

A: I would define the scope of international financial architecture as the institutions, policies, and practices that deal with crisis prevention or crisis resolution.

The second deals with the "elephant in the pond" hedge fund issue. Some believe that there is very little you can do about hedge funds because they are offshore. I think the taskforce's view was that as long as the hedge funds fund themselves mainly by banks and security firms in G10 countries and as long as they are regulated, the cost of borrowing hedge funds are indirectly affected. Thus, by indirectly affecting the lenders' behaviors, we are indirectly affecting hedge funds themselves.

We think the IMF should only make loans if there is private sector parallel burden-sharing. So that part is rule-like. Beyond that, I think you have to go case by case because every situation is very different and it is very difficult to come up with very detailed rules.

A: In your discussions, did you seriously consider the implementation of the Tolbin Tax?

Q: We did discuss it. There are many approaches. One is the liquidity defense where there is a very high bank reserve requirements for banks, which can be lowered during a crisis, or the Argentinean approach. The second is the Chilean approach where there is a round tripping tax, which is adjustable according to the economic environment. The third way would be to have a global system to deter a short-term in and out trading, which is very difficult. There is a need for a universal implementation to go on a global basis. What you see in Asia after the crisis is the build up of liquidity defense. The problem with the liquidity defense is that you need huge reserves. There is no one easy solution.