Reforming the International Financial Architecture

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“The G20 Leaders’ Process Five Years on: An Assessment from an Asian Perspective”
Organized by Lowy Institute, ADBI and KDI

Sydney, 23 May 2013
Issues

• Is the international financial architecture adequate for Asia?
• What lessons can be learned from the global financial crisis (2007-09)?
• Is the IMF performing its expected role, in the area of surveillance, crisis lending and conditionality, and policy advice?
• How should Asia respond?
Outline

1. Introduction: Why Reforms?
2. Surveillance
3. Managing Capital Inflows
4. International Financial Safety Nets
5. Reform of the US Dollar-based Reserve System
6. Other reforms
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1. Introduction: Why Reform?

A well-functioning international financial architecture should:

- avoid exchange rate instability,
- facilitate current account adjustment,
- provide sufficient international liquidity for the world economy,
- support confidence in the system, and
- promote international trade and investment.

In sum, it should create a stable international financial environment for sound national economic policymaking.
The GFC could not be prevented

- Global surveillance mechanism (IMF, BIS, OECD, G-8) did not work
- Pre-GFC attempts to strengthen standards & codes and data transparency—outcomes of the Asian financial crisis—did not work
- The IMF/WB supported FSAP had a limitation

Development of the EZFC could not be predicted/prevented either

- Excessive emphasis on “global” imbalances and underestimation of the importance of intra-EZ imbalances
- Inadequate institutional mechanisms in the EZ—no fiscal union, no banking union, no financial safety nets (before the crisis)
But the international financial system worked relatively well during the GFC

- Exchange rates among major economy currencies, except for the RMB, were flexible, with the US dollar’s appreciation
- Pre-war type competitive devaluations or systemic trade protectionism were avoided
- Internationally concerted fiscal stimulus measures were implemented
- Aggressive monetary policy responses (de facto zero interest rate and QE) were adopted
- International support for the IMF and MDBs was reaffirmed

Essentially the G20 mechanism worked well
Reform is still needed

• Problems of the international financial system:
  - Exchange rate volatility
  - Capital flow volatility and recurrence of currency & financial crises
  - Global imbalances (though declining)
  - Need for financial regulatory reform to prevent the recurrence of GFC and to support growth
  - Rise of sovereign debt globally
  - EZFC needs fundamental resolution
  - Ultra-easy monetary policy in developed economies, affecting emerging economies

• The use of the US dollar as the most dominant international currency creates tension between national interests and global monetary stability

• IMF governance reform yet to take place
2. Surveillance

(1) Failures to identify vulnerabilities before the financial crisis

- IMF, other surveillance bodies (BIS, OECD, EU), or the private sector could not identify the underlying vulnerabilities behind the GFC (subprime loan risk, credit boom) and the EZFC, and did not issue much warning.
- Multilateral surveillance before 2008 could not be effective in addressing the global imbalance (which dissipated following the GFC).
- Need for greater focus on systemically important economies (US, EZ, Japan, China, UK) and spillovers among sectors (real, finance & fiscal) and between economies.
- IMF needs to work with regional surveillance and monitoring bodies (like EU in Europe, AMRO in Asia).
(2) Review of IMF surveillance

Triennial Surveillance Review (October 2011)

• IMF surveillance seen as too fragmented, with risk assessments lacking depth and insufficient focus on interconnections and transmission of shocks
• Surveillance found to have less impact for larger member countries

Improvements in six key areas recommended:

• Interconnectedness: WEO, GFSR, REO
• Risk assessments: Vulnerability exercises
• Financial stability: Financial Surveillance Strategy, FSAP, work with FSB to improve macro-financial surveillance
• External stability: A pilot External Sector Report
• Traction: Strong analysis, candid & evenhanded advice
• Legal framework: Integrated Surveillance Decision
(3) Regional surveillance in Asia

- ASEAN+3 finance ministers have:
  - Launched the **Economic Review and Policy Dialogue (ERPD)** process to conduct regional economic and financial surveillance
  - Created the **ASEAN+3 Macroeconomic Research Office (AMRO)** in Singapore as a secretariat for ERPD

- Next steps for AMRO
  - Provide sufficient resources for AMRO
  - Support ERPD processes among the finance ministers and central bank governors
  - Develop a “peer review” process
  - Facilitate concerted action & informal coordination

- Asia also needs to set up an **Asian financial stability dialogue (AFSD)** among the region’s financial authorities to promote regional financial sector stability
3. Managing Capital Inflows

(1) Risks of capital inflows

- Benefits of capital inflows
  - Greater economic opportunities and cushion against shocks: to expand investment, smooth consumption, and diversify risks
- Risks of excessive & volatile capital inflows
  - Loss of macroeconomic stability
  - Damage to financial stability
  - Risk of sudden capital flow reversals

*Ultra-easy monetary policy in developed economies can aggravate these risks*
(2) Role of IMF in capital flow management

- IMF’s position on capital controls has evolved since the Asian Financial Crisis of 1997-98
  - Has recognized risks associated with capital flow volatility
  - Earlier already accepted some less distortionary prudential measures, such as URR on capital inflows
  - Has introduced the concept of capital flow management, including capital controls in policy toolkit

- There is no silver bullet solution
  - The best policy combination depends on specific country conditions
  - IMF needs to make country-specific policy advice on capital flow management, including capital controls and their eventual unwinding
(3) Emerging economies’ policy responses to inflow surges

• **Structural measures**
  – Develop and deepen financial markets
  – Liberalize imports and capital outflows

• **Macroeconomic measures**
  – Sterilize FX market intervention
  – Ease monetary policy
  – Tighten fiscal policy
  – Allow exchange rate appreciation

• **Macroprudential measures**
  – Tighten macroprudential supervision and regulation over domestic markets
  – Control short-term capital inflows
4. International Financial Safety Nets

(1) Modalities

- IMF lending facilities to promote automaticity and precaution in the event of externally driven financial turmoil (FCL, PLL)
- Central bank bilateral currency swap arrangements (US Fed, ECB, BOJ, PBoC)
- MDBs’ contingency support
- Regional financing arrangements (EFSF and ESM in Europe, CMIM in Asia, FLAR in Latin America, AMF in GCC, etc)
A rapid (temporary) loss of reserves and won & rupiah depreciation in 2008-2009

Source: IMF, International Financial Statistics, online
(2) IMF lending and conditionality

• IMF seems to be working well with the European institutions, but IMF stigma persists in Asia
• IMF stigma may be lessened by new lending programs aimed at flexibility and timeliness
  – RFI (Rapid Financing Instrument) a good direction for balance of payments emergency, without the requirement for a full-fledged programs or reviews
• IMF conditionality and program reviews
  – Have become more tailored to country-specific pre-conditions and different policy constraints
  – New facilities (FCL, PLL) rely more heavily on ex-ante conditionality

* FCL: Colombia, Mexico, Poland
** PLL: Morocco
(3) Strengthening the CMIM

- Next steps for CMIM
  - Create a more solid funding structure
  - Increase the size of the facility available for each member
  - Make flexible use of the new precautionary instrument, without ex-post conditionality, like IMF’s FCL & PLL
  - Reduce its link with IMF over time, ultimately to zero, by strengthening AMRO & ERPD
  - Expand membership to include Australia, India & NZ

- With these reforms of CMIM and a strong AMRO, a de facto AMF will have emerged

** Japan and China cooperation essential:
  - CMIM: Japan 32% and China 32% (Hong Kong 3.5%, mainland China 28.5%)
  - AMRO: A Chinese as the first head for 1 year, followed by a Japanese for the remaining 2 years
  - Reference: CGIF contributions: Japan 28.6%, China 28.6%, Korea 14.3%, ASEAN 10%, ADB 18.6%
(4) IMF and regional approach

- IMF may take an integrated view over various types of financial safety nets (bilateral, MDBs, regional, and others)
- IMF needs to work with regional arrangements
  - Troika with the EU and EFSF in the Eurozone
  - Possible troika with AMRO and ADB in Asia
- IMF and regional surveillance bodies (EU and ECB in Europe and AMRO and ADB in Asia) can create synergy
- CMIM must work with IMF for large-scale crises, though it can take care of small-scale crises
5. Reform of the US Dollar-based Reserve Currency System

(1) Options

• A new US dollar standard
  - More responsible policymaking by the US
  - US Fed as the global lender of last resort

• A genuinely global reserve currency system
  - SDR as major alternative reserve assets

• A multi-polar reserve currency system
  - Recovery of the Eurozone essential
  - Asia needs to find its own currency (yen?, yuan?, or a currency basket?)
Assessments

None of these is likely to emerge in the short run

- The US has no incentive to adopt a new dollar standard as it would constrain policy freedom
- The US (and many other major advanced economies) would have no incentive, either, to make the SDR a global reserve currency
- For the SDR as a viable reserve currency, private markets must develop for its instruments
- Nonetheless, it would be useful to broaden the SDR composition by including major emerging economy currencies that are fully convertible
- It will take time for a multi-polar reserve currency system to develop
(2) Use of Asian currencies

- Bilateral currency swap arrangements
- Further progress on Asian bond market development
- Use of local currencies for bilateral trade invoicing between Asian countries
- Mutual holdings of sovereign debt as official foreign exchange reserves
- Development of direct currency markets for the Asian currencies

- For these purposes, Asian policymakers must:
  - Pursue capital account opening prudently
  - Develop deep, liquid & open financial markets
  - Avoid excessive volatility of intraregional exchange rates
(3) Develop and open financial markets

- Asia needs to develop and open financial markets in a prudent way
  - Liberalize cross-border capital flows
  - Harmonize capital market regulations
  - Introduce mutual recognition to capital markets

- This would encourage international use of Asian currencies for trade, investment and other purposes

- Existing initiatives of local-currency bond market development need to be further strengthened:
  - Asian Bond Funds, Asian Bond Markets Initiative, Credit Guarantee and Investment Facility
6. Other Reform Agendas

(1) IMF governance reform

Shares and chairs reforms

• IMF Quota
  - Reform of 2010 will increase its equity capital to $720
  - 6 percentage points towards developing countries
• 2 of 24 IMF directorships from European countries to developing countries
• But the US has yet to ratify the 2010 reform
• Next round of IMF quota reforms is due to complete in January 2014

Restoring credibility and trust of IMF

• Quota formula and the review of Board composition must be made more transparent
(2) Global regulatory reform

• G20 agreements reached so far:
  – Requirements for greater quantity and quality of capital
  – Liquidity requirements
  – Leverage ratio
  – Standards for OTC derivatives markets (by 2012)
  – Identification, surveillance, regulation and resolution of systemically important financial institutions, especially global ones (G-SIFIs)

• G20 issues expected to be finalized soon
  – Strengthened oversight of shadow banking
  – Compensation and credit rating agencies
  – Development of macroprudential frameworks and tools
  – Convergence to strengthened international accounting standards
  – Strengthened adherence to international supervisory and regulatory standards

• A need to balance financial development/inclusion and financial stability for emerging economies
(3) Mobilization of savings for long-term investment

Need for long-term funding for infrastructure and SME investment

- Need for financial markets to support growth through long-term investment, while ensuring financial stability
- Development of local-currency funding market
- Asset management industry for post-retirement income schemes (pension funds, etc)
- Financial inclusion
- Stronger supervisory/regulatory framework and capacity
- Prudent processes for financial market opening and capital account liberalization
7. Conclusion

• Urgent need for reform of IMF surveillance, lending, and governance
  – To help reduce IMF stigma, flexible and timely advice and programs focusing on country-specific conditions, i.e. RFI and fine-tuning capital flow management
  – Quota increase and more director chairs toward developing countries
  – Transparent quota formula and review of the Board composition

• Volatile capital flows remain a major risk for emerging economies, and capital flow management measures must be part of policy to secure financial stability
  – A country-specific set of policy measures (structural, macroeconomic, and macro-prudential) useful

• Tighter financial regulation and supervision must balance the need for financial stability and the need for financial development & inclusion and sustainable growth
Conclusion (cont’d)

• Although the US dollar does not play an adequate role as a truly international currency, the US dollar will likely remain dominant for some time to come.

• Asian countries should make efforts to develop and deepen their financial markets so that their currencies can be used more frequently for international trade, investment and finance.

• A regional approach can be an important solution for international financial stability, contributing to IFA reform:
  – Regional financial stability: CMIM, AMRO, and an Asian financial stability dialogue (AFSD), in cooperation with the IMF and FSB.
  – Local-currency bond market development: ABMI, ABF, CGIF.
Thank you
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