New Financial Architecture

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One of the most important messages of the recent financial crisis in emerging markets is that globalization will continue to mark the economic and financial developments in most economies. This is a practical conclusion that arises from observing the decisions taken by policymakers in emerging economies as they confronted the crisis. Also, this message strengthen the policy conclusion that the process of economic –and especially financial– integration with the rest of the world needs to be carefully monitored and managed, though not delayed.

The latter conclusion places a serious responsibility on all participants in the international capital markets. The challenge is twofold; first, to implement policies at the domestic level that allow emerging economies to smoothly integrate with the rest of the world, and second, to improve the financial architecture and increase the efficiency of the world capital markets. The topic under discussion is, therefore, what policies and institutions should be promoted on a national, regional, and global scale to achieve greater economic and financial integration, but without the abrupt disruptions of recent years.

I will focus my remarks on the policies that countries should implement at the domestic level. While a new global architecture may reduce contagion, herding behavior or other undesirable effects, emerging economies will obtain greater benefits by focusing on domestic institutions and policies.

The long-standing assumption that the case for liberalizing capital account transactions is analogous to that for liberalizing trade has come under serious review. Recent debates accept the idea that capital account liberalization carries major risks and needs to be carefully managed. This has produced an stimulating discussion on the policies required to confront financial integration. The discussion has focused on five main issues, namely, the speed and sequencing of capital account liberalization, the role and effectiveness of capital controls, the exchange rate regime, the strength of the domestic financial system, and the quality of macroeconomic policies. I will discuss the Chilean experience on these particular issues.

1. Strengthening the domestic financial system

Increased volume and volatility of capital flows may endanger the financial stability needed for economic growth. Thus, a country that receives large capital inflows and that has not made the necessary structural reforms will most likely fail to reap the full benefits of financial integration.

In the late 70s, foreign capital flowed to several Latin American countries, Chile included, mainly in the form of syndicated bank loans. These flows were driven by domestic financial liberalization and by increased liquidity in the international capital markets. The Chilean banking sector had been recently deregulated, was poorly capitalized and weakly managed and supervised. Thus, these inflows fueled an expansion of banks' balance sheets, increasing their exposure to currency, liquidity, market and credit risks. The result was similar to what we have witnessed in some East Asian countries in recent years.

Thus, here comes the first conclusion: capital account opening has to be accompanied by—and preferably preceded by—an overhaul of the country's capacity to supervise, regulate and manage financial institutions, so that the domestic financial system can properly cope with the complexities that go with free capital movements.

2. Transparency, market discipline and corporate governance

There are a number of initiatives under the label of transparency, comprising new disclosure and accounting standards. All of them aimed at enhancing market discipline and good governance in the banking and corporate sectors. In general, all these seem like entirely reasonable proposals and many countries have already embraced several of them with favorable results.

After the debt crisis of the early 80s, Chile accomplished several reforms to increase transparency and to strengthen market discipline and corporate governance. Three are worth mentioning, namely, new laws ruling the activities of banks, finance companies, and corporations; a new bankruptcy law; and a new tax code. For instance, the banking law imposed more stringent disclosure requirements on banks, explicitly limited the coverage of deposit insurance to small depositors, and established clear procedures for the closure and liquidation of insolvent institutions. Similarly, the tax code significantly reduced the incentives for debt instead of capital financing by eliminating the double taxation of dividends and providing other tax incentives.

The second conclusion is, therefore, that strengthening market discipline and self-regulation of banks and other corporate entities is an important objective, given the rapidly changing business environment in a global economy, especially in financial markets. The main challenge in this area is to design and maintain a regulatory framework flexible enough to encourage market development while, at the same time, to enhance market discipline and self-regulation.

3. Sound macroeconomic policies

But, is improving the regulatory and institutional framework enough to ensure stability in an economy that is integrated (or integrating) with international financial markets? Experience shows time and again that a sound macroeconomic environment is also needed. Financial integration carries risks and undesired reactions that, in turn, may increase vulnerability and expose stability.

First, there is the risk of overheating due to the (excessive) spending fuelled by the rise in capital inflows. The overheating, in turn, may lead to inflationary pressures and endanger the price stability policy. Furthermore, the real exchange rate may tend to appreciate beyond what is consistent with a reasonable deficit in the current account; and experience shows that the size of the current account deficit matters, even if it is originated in excess private spending.

The Chilean experience at the beginning of the 80s, like that of other emerging economies more recently, teaches that the authorities cannot leave these developments unattended. Indeed, in the early 80s internal savings fell notoriously in Chile, investment increases were primarily oriented towards the non-tradable sector and the real exchange rate appreciated sharply. The latter made economic and financial activities highly vulnerable to external shocks.

Here comes the third conclusion: pursuing sound macroeconomic policies and avoiding domestic and external imbalances are important to preserve stability in financially open economies. Thus, the Chilean response to the increase in capital inflows in the early 90s was a policy-mix consisting of a steady fiscal surplus, greater exchange rate flexibility, a relatively tight monetary policy and (heavy) sterilization. All of these were aimed at maintaining the price stabilization program and keeping the current account deficit within a sustainable range.

However, it is important to admit that these policies have limitations. A steady fiscal surplus is pro cyclical and heavy sterilization is costly. Thus, a sound policy framework needs to be complemented by buffers and increased transparency. Holding a relatively large stock of foreign reserves, using counter cyclical fiscal instruments and adapting the economy to greater exchange rate flexibility may become useful buffers. But other ideas are also being considered, in particular, contingent credit facilities with private international banks (like the Argentinean one), regional self-insurance funds, or the IMF's CCL. Also, increasing transparency in policy-making can reduce the frequency of crisis by alerting markets and policy-makers of difficulties on the horizon, forcing early corrective actions.

4. Prudential regulation of the capital account

Like the Chilean crisis of the 80s, the recent experiences in Asia deviate from the standard presumption that failures in monetary and fiscal policies lie at the core of every balance of payments crisis. Instead, like Chile, Asia essentially presented excessive borrowing and risk taking by the private sector. Thus, is sound fiscal and monetary policy enough to prevent financial crisis? The answer seems to be no.

The fourth conclusion is that in certain cases, due to market failures (sometimes policy-induced) there is room for prudential regulation of the capital account, aimed at changing the composition of capital inflows and giving monetary policy more flexibility to pursue inflation or current account targets. In this respect, between 1991 and 1998, Chile applied a reserve requirement that placed a wedge between domestic and foreign interest rates, and provided a disincentive to short-term capital. The reserve requirement had the form of a non-remunerated deposit that affected most forms of external financing, including foreign credit and foreign-currency deposits, but excluding productive equity investment like FDI. The deposit had to be kept in the Central Bank for a year irrespective of the maturity of the foreign inflow. Its objectives were first, to favor equity over debt and long- rather than short-term financing, and second, to increase the effectiveness of monetary policy (i.e., to allow the implementation of a tight monetary policy without resulting in large capital account surpluses).

A frequent question is whether the reserve requirement has been effective in achieving its objectives. It is worth emphasizing that this is one instrument in a broader consistent set of macro (and micro) economic policies. However, in spite of its controversial nature, this prudential control induced a significant change in the composition of capital inflows. Indeed, FDI and longer-term portfolio investment grew in importance relative to foreign debt. There was also a change in the composition of foreign borrowing, where medium- and long-term debt increased its share in the total. There is also preliminary evidence, although rather weak, that the reserve requirement reduced the inflows, and, consequently, the excess appreciation and the volatility of the real exchange rate. In this assessment one should bear in mind that capital inflow averaged 7% of GDP in 1990-97 and peaked to around 10% of GDP in 1997. It is also important to note that due to legal limitations the regulations could not be imposed to all flows, thus leaving lop holes that reduced its effectiveness.

However, the Chilean experience with capital controls needs to be studied in greater detail before reaching more robust and final conclusions. It would be wrong at this stage to extrapolate this experience and conclude that capital controls should be applied in the same fashion to other emerging economies, however there are some lines of work suggested by the Chilean approach.

The ongoing work in this area examines the experience of other countries in using different forms of capital controls, and in liberalizing different components of the capital account. This inquiry relates with the more general notion that countries should encourage equity rather than debt flows, and long- rather than short-term flows. A credible legal and institutional infrastructure for private investors would go a long way to achieving these goals. It is worth noting that redesigned debt contracts to include clauses for a bailing-in –or orderly workout– in case of default may achieve analogous results in terms of reducing the importance of debt in international placements. Also, a similar outcome may be achieved by incentives, at the country level, to issue securities denominated in local currency in the international markets. Likewise, an information system on the external liabilities and assets of domestic residents constitute an essential element for efficient market operation and adequate policy design. Additional research and a careful analysis of these and other alternative measures are needed at this stage to establish stronger conclusions for best practices in this regard.

5. Exchange rate regime

Considering that prudential regulation of the capital account has limited effects, one may raise the question about how the exchange rate regime may help to ensure stability in a financially integrated world. The Chilean experience in the 90s shows that exchange rate flexibility and a nominal anchor are two necessary ingredients for an efficient regime.

But, flexibility needs stable and low inflation in addition to liquid and deep financial markets, especially derivative markets for risk coverage and hedging purposes. Thus, due to generalized indexation practices and a past of high inflation in Chile, a credible nominal anchor is of critical importance. The strict inflation target, announced by the authority each year, has been effectively used to set the path for domestic prices and significantly reduce inflation in recent years. In order to support this policy the Central Bank had no option but to intervene and limit the volatility of the exchange rate during some episodes in 1998. This intervention was also needed as financial markets are still at an early stage of development in Chile.

Thus, floating exchange rate regimes are not a panacea for the stability of the domestic financial system in the presence of volatile capital flows. There is a trade-off between targeting the real exchange rate in order to limit the current account deficit, and let the market assess exchange rate risk. If the exchange rate policy is used to sign a path for the real exchange rate, the result will be a distortion in the market appraisal of exchange rate risk and excessive capital flows. On the other hand, free floating may lead to transitory misalignments of the real exchange rate, although the pricing of the associated risk will be correct. To sort out this tangle an economy needs a strong domestic financial system with well developed hedging mechanisms, and a good record of low inflation that leads to a small pass-through from devaluation to inflation. The exchange rate flexibility by itself cannot avoid external imbalances, and the appropriate monitoring and timely policy actions are required to maintain macroeconomic stability.

6. Conclusions

A new financial architecture that leads to better functioning of international capital markets is a desirable goal. This is necessary to reduce contagion, herd behavior or bandwagon effects. Currently the multilateral financial institutions, academia and other entities are taking major steps to improve the framework and designing new instruments to allow more smoothly functioning of international markets. An important step in this regard is to improve the reporting and monitoring of capital flows, especially private sector short-term flows related to inter-bank transactions, and of direct placements and consolidated debt of the corporate sector in emerging economies.

Nevertheless, the latter is not a substitute for good domestic fundamentals. Moreover, some time will pass until adequate institutions ruling cross-border financial transactions are designed and put to work, and emerging market economies will achieve a lot more in the short and medium term through actions to make them more resilient to shocks. In the end, it rests primarily with each country to manage its own affairs to gain the undoubted benefits of access to the pool of international savings, while avoiding the damage from over-indulgence.

The Chilean experience exhibits the risks and options concerning international capital mobility. Although it is always difficult to extrapolate, the experience of the 90s provides an example of the importance of building a more stable basis for cross-border investment flows rather than trying to act directly to stabilize or control those flows. Based on this experience, we strongly believe that greater stability will be achieved in the medium term by allowing the adverse effects of shocks to be spread across several markets and variables. In emerging economies with structural rigidities, imperfect institutions and incomplete markets, it would be a mistake to leave the whole weight of the adjustment to fall on one particular variable (or market). Hence the need to build buffers across the entire economic system. In this regard it is important to emphasize that having well capitalized banks, accompanied by strong management and supervision, reduces the chances of crises. Similar positive effects arise from sustaining a strong fiscal position. But that may not be enough. At the margin and when accompanied by consistent policies, some types of prudential controls may help to avoid certain risks such as excessive reliance on rolling over short-term debt. Similarly, flexible exchange rates works better when other conditions are in place, such as deep financial market offering adequate hedging mechanisms, continuous price stability and low indexation.