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WAYS TO IMPROVE THE FUNCTIONING OF FINANCIAL MARKETS

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1. For their economic progress, developing countries are particularly dependent on regular inflows of capital. Since official assistance (whether bilateral or multilateral) is always available only on a strictly limited scale, developing countries depend primarily on inflows of private funds. This is why it is of crucial importance to them that:

– international financial markets function properly and lastingly, and
– individual countries have proper and lasting access to such markets.

2. Professor Griffith-Jones' paper mentions the headway made in the past few years in the area of international financial reform. Quite rightly, she highlights the following points:

– the further development and restructuring of some activities of the IMF and World Bank,
– the establishment of the Financial Stability Forum (FSF) in Basle,
– the supplementing of the ongoing cooperation between the G-10 countries by the new G-20 grouping, and
– the intermediate evolution of many codes and standards for the financial markets and for the supervision of financial systems.

Unlike Professor Griffith-Jones, however, 1 regard the new facility set up by the IMF -Contingency Credit Lines (CCL) – as not unproblematic. Any country seeking to avail itself of such a facility signals to the markets that it is susceptible to crises, and may well therefore do itself harm.

3. But I agree with the general statement that the reform measures taken to date do not suffice, and must be continued. That goes particularly for the implementation of greater transparency in the international financial markets, and for the further development of systems of supervision over financial institutions. It would also be highly desirable for

standstill and orderly workout procedures to be devised at an international level in the foreseeable future. In view of the substantial differences between the prevailing national legal systems and legal traditions, however, progress in the internationalisation of such legal regulation is likely to be very slow (if possible at all).

4. I have substantial reservations, though, about the proposal to enlarge IMF resources in cases of emergency by means of temporary and self-liquidating issues of SDRs. In the first place, if only because of the current practice of the IMF, I have my doubts as to whether it actually needs more resources for its role as a catalyst in overcoming crises. The danger of moral-hazard effects for borrowers and lenders alike would, if anything, increase if IMF loans were even larger. Secondly, in the event of a major crisis, the IMF can draw on the resources of the biggest central banks in the context of the enlarged General Arrangements to Borrow (GAB), which act as a kind of reserve for crises. Any 'lender-of-last-resort' function of the IMF going beyond that is, I think, neither necessary nor appropriate. In the light of experience to date, it can hardly be asserted, incidentally, that there is any global shortage of liquidity.

5. By contrast, I regard the criticism of the asymmetry of the present reforms, as mentioned in the paper, as being partly warranted. That applies, for instance, to official membership of the FSF, which (contrary to my original idea) was initially confined to G-7 countries, mainly on grounds of efficiency, in response to US pressure. In the meantime, however, FSF composition has been changed, at least in part, by the inclusion of some emerging economies. Moreover, there are nowadays a number of informal participations, by individual experts in working parties, – a form of participation which, anyhow, is more important for the work of the FSF than official membership.

6. The third asymmetry mentioned in the paper, according, to which too, little account is taken in the IMF reforms to date, and in the work of the FSF, of the low-income countries, to the detriment of the middle-income countries, is in my view right and wrong at the same time. What is right is unquestionably the fact that the IMF and the FSF must concern themselves, in the -light of their mandates, primarily with the middle-income countries and the emerging economies. Support of the low-income countries is, first and foremost, a task for the World Bank (as a development institution) and the regional development banks. This division of responsibilities is a consequence of their differing mandates, and it should not be blurred any further.

7. As the paper rightly says, all future efforts should focus above all on improvements in the information on the functioning of the markets and on statistical data. To that end, both sides (both the developing countries as borrowers and the private financial institutions as lenders) must contribute by supplying up-to-date figures and by actually using them for market assessments. Thanks especially to the activities of the BIS in Basle, the FSF and the Institute for International Finance, considerable progress has meanwhile been made on the lender side. Not only are all loans by the major financial institutions classified by country and by maturity and published promptly; nowadays, there are also regular exploratory talks between many borrower countries and private financial institutions. After all, it is vital that the developing countries, too, recognise in their own interests the growing importance of unambiguous and up-to-date information. Enhancement of the flow of information, and its exploitation, must be a two-way road.

Furthermore, the actual application of the standards and codes meanwhile devised for the supervision of national financial systems is an issue of major significance. Although the number of such standards and codes has currently risen to over 60, the FSF has singled out only twelve of them as being essential to the functionality of financial systems and markets. In my view, it cannot be said, on closer inspection, that there is any asymmetry in those standards and codes to the detriment of developing countries.

8. The chapter 'Improved international financial regulation' contains many detailed proposals, which, however, are designated only as 'initial thoughts' in the final sentence. Quite apart from the fact that, in matters of detail, these proposals raise quite a number of unresolved questions, and that their political prospects of realisation must be rated very low, a question of principle is presented here which the paper answers, in my view, one-sidedly, without addressing details. This is the diagnostic question as to whether the crises in the past were caused primarily by imperfections in the financial markets themselves or predominantly by mistakes in the policies pursued by the countries affected. The paper apparently concludes that the main cause of crises is the failure of the international markets, and less the failure of the national policies of the countries concerned.

In the light of my own practical experience, I am able to agree with such a verdict to only a very limited extent. In my estimation, the causes of crises have almost always been problematic policy decisions by the countries concerned, sometimes actually fostered by problematic policy recommendations by the IMF or by other countries.

Alongside domestic structural and macroeconomic unwelcome developments in the policies of the countries affected, most of the crises of recent decades have also owed something to the overly rapid decontrol of capital movements and/or unrealistic exchange-rate ties. Although these policy errors have mostly yielded short-term benefits in terms of capital inflows and the relevant conditions, in the medium and longer term they have often given rise to serious economic disequilibria and distortions in financial flows, which have engendered extreme turnarounds if market expectations have changed.

Happily, at least a number of countries have meanwhile learned from such mistakes, and modified their policies. The IMF, too, has largely adjusted its recommendations accordingly. Nowadays, it attaches greater importance to correct sequencing in the decontrol of capital movements, and, in the normal case, it advocates greater exchange-rate flexibility than it used to.

10. Generally speaking, the objective of preserving the lasting functionality of the markets should form the focus of all efforts to further develop the global financial system. Judging by past experience, markets are more easily able than political institutions to fruitfully reconcile the divergent interests of borrowers and lenders.

Given the dominance of national interests and of thinking in terms of national prestige, international institutions can exercise an effective compensatory and regulatory function to only a limited degree, as the practical experience of most international organisations shows. 'Grand design' drafts of a new global financial architecture spark off countless controversial debates, on past experience; but such political discussions of principle not infrequently obstruct potential concrete progress. Economic practice shows that informal bodies, such as the FSF and the other talking shops (especially those under the wing of the BIS), are most likely to make actual progress possible.