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Supervising the International Financial System

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Introduction

As the Group of Eight (G8) evolves, the elite club has shown that it is willing to tackle issues that are domestic in nature yet have an international linkage. That is, domestic issues that share a commonality across member nations or have considerable externalities become part of the agenda. Issues of aging populations and employment levels are examples. On the other hand, the G8 has also shown a preference to delegate to international bodies international issues that may affect member nations to varying degrees.

In many cases, the delegation of responsibility is wise. In the case of infectious diseases, developing an agenda and delegating responsibilities to the World Health Organization (WHO) is a sound managerial decision. Delegating agendas and responsibilities to international organizations that are ill-equipped or unable to deal with pressing issues, however, is at best ineffective and perhaps even reckless.

Recent responses of the G8 to contemporary economic problems, which are rooted in the financial sector as opposed to the real sector, have been to ignore, minimize, and delegate to the International Monetary Fund (IMF).\(^1\) The outcome is ineffective and reckless policymaking. In the middle of the financial meltdowns in Asian and Russia, and with contagion lapping at the shores of Latin America, a single day's editorials in the Wall Street Journal argued the following:

... Argentina is about the only nation where the (International Monetary) Fund's gotten it right since the current crises began with the Mexican bailout back in 1994... The issue is not simply the large amount of money, but also an IMF record that in any responsible financial institution would require the firing of senior management...\(^2\)

In the same article George Soros made the following remark about the response of the G7 nations to the crisis:
The third major factor working for the disintegration of the global capitalist system is the evident inability of the international monetary authorities to hold it together. IMF programs do not seem to be working. The response of the Group of Seven industrialized countries to the Russian crises was woefully inadequate, and the loss of control quite scary. 3

By not handling the recent financial crises in a timely or effective manner, the G8 has demonstrated that, either by choice or by inability, it is not an institution of effective global leadership in the areas of deepest importance. Important issues of financial bailouts and coordination of supervision and regulation must be resolved prior to the new millennium.

Section 2 of this chapter examines the dramatic increase of capital flows to developing economies and the importance of financial intermediaries in channeling these funds. Section 3 outlines the various risks brought about by greater integration of capital and money markets. Section 4 presents views on government regulation of domestic financial systems and considers the capacity of existing international organizations to fulfill this role. Section 5 outlines the critical responsibilities of the Group of Seven (G7) and G8 in light of 1997-98 financial crises. Section 6 offers a conclusion.

**Evolution of Capital Markets**

During the Bretton Woods System, capital flows were relatively limited. Hence, most capital flows and foreign exchange transactions occurred to finance and facilitate transactions in the real sector. As a result, a typical international payments crisis was a slowly developing payments imbalance driven by transactions in the real sector. Bretton Woods institutions such as the IMF and the World Bank were relatively well equipped to deal with these types of crises.

Following the advent of a floating exchange rate system, most of the industrialized nations began to remove capital restrictions and deregulate their domestic monetary and financial markets, beginning with the United States and Canada in the early 1980s. The daily volume of foreign exchange transactions mushroomed from approximately $15 billion in 1973 to $1.4 trillion in 1998, a volume that is several times larger than the daily volume of transactions that occur in the real sector. In addition, cross-border transactions of bonds and equities in the United States (U.S.) increased from 9 percent of Gross Domestic Product (GDP) in 1980 to 164 percent in 1995 (Daniels and VanHoose, 1999, p. 174).
Increased Capital Flows to Developing Economies

Arguably more important has been the increased volume of capital flows among nations. Indeed, the most striking feature of the 1990s, is the increased volume of capital flows to the emerging countries. Figure 7.1 illustrates the rise in total net private capital flows for the emerging economies, distinguishing between net direct investment flows and portfolio flows. As shown in the figure, net private capital flows to the emerging economies has risen a dramatic 415%.

Figure 7.1 Net Private Capital Flows to Emerging Economies, 1990-96
As learned in the 1994-1995 Mexican financial crisis, it is important to recognize the proportion of net private capital flows that are portfolio investments. This flow of short term capital, often referred to as "hot money", can reverse direction quickly, leaving a nation's financial sector in an illiquid position. (See Chang and Velasco, 1998, for an excellent review of the Asian liquidity problem.) Figure 7.1 shows that for the emerging nations, the largest proportion of net private capital flows was net portfolio flows until the Mexican financial crises occurred.

Figure 7.1 also demonstrates that the proportion of net portfolio flows to total private capital flows differs widely across the various regions. For the Middle East and Europe, net portfolio flows account for 42% of total private flows, while it is a mere 8% for the transitional economies. The fact that portfolio flows can reverse quickly is evident in the Western Hemisphere region, where net portfolio flows dropped by $68.3 million in 1995 alone, representing a 112% decline. Net direct foreign investment flows as a percent of total net private flows range from 58% for the transitional economies to a scant 7% for the Middle East and Europe economies.
The Importance of Financial Intermediation

It is important to recognize that the capital flows described above are the savings of one nation's residents being loaned to another nation's residents. Financial intermediaries play an extremely important role as they channel these savings to borrowers and help finance domestic investment. The solvency of a nation's intermediaries is critical for the stable flow of capital and continued growth and prosperity.

Unfortunately, history has shown that financial systems and intermediaries are quite fragile. The IMF estimates that since 1980, 133 of the 181 member nations have experienced banking problems considered to be significant (Lindgren, et al, 1996). According to available estimates, the cost of the 1977 through 1985 crisis in Spain amounted to 17% of its output. In the Nordic countries, the costs of the banking crises that occurred in the late 1980s and early 1990s amounted to 8% of Finland's output, 6% in Sweden and 4% in Norway. The cost of the savings and loan crisis in the United States totaled at least $200 billion, or 3% of U.S. output (Goldstein and Turner, 1996).

The banking crises in the developing nations have tended to be much more severe. It is believed that the costs of the 1980's banking crises in Argentina equaled one-half of the nation's GDP. The Mexican crisis amounted to a loss of 12 to 15% of output. The costs of the 1997-98 crises will be considerable. The 1995 real estate collapse in Japan resulted in the nonperformance of more than $250 billion in bank loans. In South Korea more than 10% of all bank loans were non-performing by 1998. For India and China the number of non-performing loans are estimated to be nearly 20% of outstanding loans.

As one might suspect, given the increase in international capital flows, over 354% from 1986-98 (Daniels and VanHoose, 1999), very few nations' capital investment projects are purely financed by domestic intermediaries. Even investment in the United States that is bank-financed increasingly relies on foreign banks, as the largest U.S. corporations use, on average, the services of foreign banks more than domestic institutions. Given the heightened level of integration, a nation's system of intermediaries is now exposed to new sources of risk.

New Sources of Risk

The growth and globalization of capital markets has brought about a vast
number of new opportunities for savers and borrowers. It has also generated new risks. There are five particular sources of risk examined here: 'hot money' flows, systemic risk, contagion, increasing sophistication of financial instruments, and regulatory arbitrage.

Hot Money Flows

As demonstrated in the previous section, there has been a dramatic increase in short-term portfolio flows, particularly to the emerging economies. Many of these emerging nations have financial and banking sectors that are underdeveloped, not regulated, and not properly supervised. When positive, these net inflows can put upward pressure on a nation's currency and on domestic inflation. On the other hand, they also represent a lower cost form of financing (hence lower interest rates) and stimulate a nation's economy.

Portfolio flows can, however, reverse direction at rates that quickly exhaust the cumulative buildup of years of inflows. In an economy with an underdeveloped financial sector, these outflows may result in an illiquid banking system and put downward pressure on the nation's currency. Under a fixed exchange rate regime, the government is faced with opposing problems: The banking system needs additional liquidity while the exchange rate regime requires higher interest rates. This is the type of problem seen in the 1997-98 financial crises (see Glick, 1998, for a survey of the literature in this area).

Herstatt Risk

A second aspect is Herstatt Risk or credit risk that spans borders and/or time zones. In 1974, German banking regulators closed the failed Herstatt bank at 3:30 p.m., after the bank had received European foreign exchange payments but before it made required payments to U.S. banks. Because U.S. banks did not receive anticipated payments, they were, in many cases, unable to fulfill their own obligations. By the time the entire event unwound, U.S. banks had lost as much as $200 million dollars.

Transmission of Shocks

A third aspect of increased globalization is the transmission of shocks and the potential of contagion. As financial markets become more integrated, the transmission of shocks becomes possible and can even be magnified. Such
was the case of the U.S. stock market crash of the 1980s. Because of inter-twinned markets, the crash spilled into exchanges across the globe. The recent East Asian crises shows that currency crises may have the potential for regional contagion. Empirical work by Glick and Rose (1998) indicates that currency crises affect "clusters" of nations through international trade channels.

**Increased Sophistication of Financial Instruments**

As the financial markets have evolved, new and highly sophisticated financial instruments have been introduced. The use of these instruments often becomes widespread before appropriate domestic regulators and corporate managers fully understand their risks and benefits. The 1995 collapse of Barings bank illustrates this point. The same day that Peter Baring had to ask the Bank of England to intervene, and the day after the trader involved in the derivatives fiasco, Nick Leeson, faxed in his resignation, Barings was to announce and award company bonuses, including a bonus to Leeson in the amount of £450,000. The total losses to Barings is estimated to be £927 million.

**Regulatory Arbitrage**

A final aspect, one that has not received as much attention in the literature, is the impact of increased globalization, competition, and technological advances on bank structure. Regulatory arbitrage, establishing foreign offices to avoid domestic regulation, has increased dramatically due to technological advances in banking. Globalization and competition has led to increased merger activity and the creation of "mega" banks. Both activities undermine the attempts of sovereign governments to regulate and supervisor national banking institutions.

The various risks listed above heighten the importance of a sound payments system and a sound system of banks and financial intermediaries. Financial solvency is, therefore, a key policymaking issue and critical to the operation and stability of the global economy.

**The Regulation and Supervision of Financial Systems**

How should sovereign governments and international organizations respond
to the risks of increasing financial integration? It is important to first distin­
guish between international financial liberalization and financial regulation. Liberalization is the opening up of the financial market to foreign partici­pants, increasing competition and opportunities for domestic banks. Regulation is the governing of the financial sector in order to improve its operation of financial intermediation. Obviously, and as evident in the 1997-98 financial crises, appropriate regulation and supervision is required for the domestic financial system to absorb and channel in an economically efficient way the inflows and outflows of capital.

Views of Government Intervention

One view of government intervention in the financial sector is that finan­cial intermediation is inherently an unstable business whose fortunes rise and fall with the business cycle and that financial markets may have inher­ent imperfections. Hence, government regulation and safety nets are required to prevent periodic banking collapses.

In line with this view, Von Hagen and Fratianni (1998) identify three main reasons for financial regulation. The first is that small deposi­tors find it too costly to continuously monitor the activities of intermedi­aries. Hence, small depositors need protection from the risk of bank fail­ure. The second is that regulation is required to prevent large withdrawals from one bank which might affect the entire industry, that is, to prevent contagion. The final reason is to preserve the integrity of the payments sys­tem. The authors assert that these types of banking regulation involve the reallocation of risk and therefore wealth among market participants. In a global setting this reallocation can become quite complex as sovereign gov­ernments wish to protect domestic residents over foreign residents.

Another view is that regulation that eliminates competition and the existence of safety nets creates a moral hazard problem and may actually be responsible for recent banking crises. This second view has been used extensively to build a critical case against the necessity of international organizations such as the IMF. It has played particularly well on the floor of the U.S. Congress who delayed approval of a new allocation of funds to the IMF until October 1998.

Regulation and Supervision: New or Old Institutions?

In spite of recent criticism, there have been a number of well placed initia-
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Responsibility of the G7 and G8

Through these recent directives, the leaders demonstrated a recognition of the comparative advantages of the supranational organizations and the ability to construct well placed directives. They were not, however, timely nor were all directives fulfilled. There are a number of pressing issues that the G7 and G8 must address. (See Sachs, 1998, for a proposed agenda and a recommendation that the G8 be expanded to a G16.)

IMF Bailouts

Arguably most important is the problem of IMF bailouts. As is frequently argued, unlimited IMF bailouts increase the moral hazard of lending and
borrowing activities. Jeffrey Sachs (1998, p. 24) argues that the IMF worked "mightily and wrongheadedely" to make the world safe for "naive 25-year-old investment bankers who do not know much about world politics". Bailouts such as that in East Asia should cease.

Recent words of the G8 indicate that nations should not expect unlimited bailouts. It appears, however, that the IMF is continuing to approach problems as it has in the past and, thus IMF actions say otherwise. It is vital that the G7/G8 formulate a coherent and consistent approach to bailouts of future financial crises. The G7/G8 and the IMF must break the expectations they helped create. It is disappointing that the strongest statement the leaders could offer at the Birmingham summit was that "it is also important to ensure that the private sector plays a timely and appropriate role in crises resolution".

**IMF Responsibility**

The G7 should shoulder the responsibility of actions being taken by the IMF. In contrast to organizations such as the United Nations, voting shares at the IMF are based on a weighted average as opposed to a "one nation, one vote" scheme. The weighted average voting power of the G7 increases for many important areas. On most issues, the G7 has 47% power and on the most important issues the G7's voting share is 70-80%. Hence, the G7 can define the broad agenda and block initiatives. In a 1998 testimony before the U.S. Congressional Joint Economic Committee, Paul Volcker (Wall Street Journal, 7 May 1998) stated that Congress "should pay less attention to the faceless bureaucrats at the IMF and focus more on where IMF policy on rescue packages really gets made. Your concerns should be addressed to Treasury".

**IMF/World Bank Capabilities**

In the longer-run, the G8 should rethink completely the role and even the necessity of the IMF and the World Bank. The G8 must first realize that the IMF is not technically equipped to deal with the types of financial crises that occur in the post-Bretton Woods era. Due to the increased integration of capital markets, the current crises have been fast-developing, financial in nature, and beyond the capacity of the Fund and other existing international organizations. As an example, the most current IMF Manual For Country Economists states:
A country will require IMF assistance when it is having balance of payments difficulties or, in other words, when the normal inflow of external savings is not sufficient to finance its resource gap, which is defined as the difference between domestic savings and domestic investment.

Next the G8 must realize that the current approach to Fund conditionality is counterproductive. Sachs (1998, p. 25), states that:

This process (conditionality) is out of hand. It has undermined political legitimacy in dozens of developing countries, especially since the IMF is often happy to conspire with governments to make end runs around parliaments in the interests of "reform". The contents of IMF programmes are too flawed to be a standard of good or poor performance. Markets realize this, so IMF programmes do less and less to rally them.

Supervisory Coordination

Finally, the G8 must further discussions on supervisory coordination. Primarily an initiative of Canadian Finance Minister Paul Martin, the issue should be expanded to include regulatory coordination in order to reduce regulatory arbitrage. In contrast to the Martin initiative, however, this should not lead to a new supranational body composed of governmental agents. It should be delegated to an agency with the greatest comparative advantage, perhaps the London Club or the Bank for International Settlements (BIS). It should also seek input from private sector practitioners as in today's financial environment, operational risk is greater the market risk. Bank management must therefore be involved.

Conclusion

It has been argued here that the G7, G8, and the summit process has failed to deal effectively with the most pressing economic issue of the day, that is, fast-developing liquidity crises of domestic financial sectors. The G7 and the G8 leaders have deferred these problems primarily to the IMF which has not the resources nor the technical ability to deal with such crises. Key agenda items should include the size and availability of bailout funds and the coordination of financial supervision and regulation. This is not an agenda for the new millennium. It is an agenda for today. At the turn of the millennium it may be much too late to address these issues.
Notes

1 According to one insider of the annual summits, the Japanese contingent brought up the impending financial problems in Thailand at the 1997 Denver summit. The other parties were uninterested and consequently the topic was dropped from discussions.


References


