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The International Financial System: A New Partnership – Speech by Mervyn King

In a speech to mark the 20th anniversary of the Indian Council for Research on International Economic Relations (ICRIER), Mervyn King, Deputy Governor, addresses current themes relating to the international financial system. He outlines the need for a new partnership between those countries exporting capital - normally developed countries - and those countries importing capital - normally emerging market economies. Mr King discusses the need for a restatement of the role of international financial institutions and a clearer understanding of their modus operandi. He says that the international financial institutions set up at Bretton Woods over 50 years ago were designed to deal primarily with problems of current account imbalances. However, one of the key differences between the world of Bretton Woods and the world today is the size and volatility of private capital flows, and major financial crises in recent years have originated in the capital account. He says that although capital flows bring real economic benefits, "flows on this scale can reverse themselves as suddenly as they appear" and "the result of such sudden and large reversals of short-term capital flows has been a series of international financial crises". He adds, "it is clear, therefore, that it is dangerous for countries to sail unprepared into the deep waters of international capital markets." A build-up of short-term debt creates vulnerabilities that can result in a liquidity run, pushing interest rates to extremely high levels.

Mr King goes on to note that investors are starting to differentiate among borrowing countries more clearly than before, leading to a greater dispersion of interest rate spreads on emerging market debt. This differentiation is a "welcome development" and "shows that the possibility of contagion from a country affected by a crisis to others initially unaffected is less than might have been the case only a few years ago".

In describing a new partnership between emerging market economies and developed economies, he says that it is useful to distinguish between measures to improve economic performance and prevent financial crises, on the one hand, and ways to resolve crises once they have occurred, on the other.

In terms of crisis prevention, recent experience suggests a number of lessons for the future. First, it is important that borrowing countries monitor and manage the maturity and currency composition of their national balance sheet. Second, limitations on official finance mean that countries should think carefully about the provision of self-insurance against a liquidity crisis. Third, experience has shown the value of

borrowing countries establishing good relationships with creditors well before any possibility of difficulty in repayment arises. Fourth, in the long run, the best way to avoid the problem of liquidity crises is for the composition of capital flows to emerging markets to move away from debt, both bank and bond, finance towards portfolio equity and direct investment. Finally, greater transparency allows better informed decisions of both borrowers and lenders, and reduces the risk of contagion by allowing markets to differentiate among borrowers.

Mr King says that, in the field of transparency, the key elements of the new partnership are, first, a commitment by emerging market economies to implement transparency about transparency by publishing reports on the observance of standard and codes (ROSCs), and, second, to provide more opportunities for emerging market countries to engage in the process of developing standards and codes.

In terms of crisis resolution, further progress is required. He says there are two good reasons for the IMF not being able to play the role of an international lender of last resort, at least for the foreseeable future. First, the moral hazard created by both lenders and borrowers cannot simply be assumed away. Second, to be effective a lender of last resort must have the ability to provide whatever it takes to deal with the immediate crisis. Mr King says the IMF is not in that position as there is no political commitment to provide the IMF with unlimited funds. In practice, however, exceptional access has often been more the norm in recent years. If creditors and debtors continue to believe that exceptional access is readily available, then international credit will be over-extended and the incidence of crisis will increase.

In response to this, Mr King argues for a "middle way" between full IMF insurance and no insurance whatsoever. He says this middle way would comprise IMF lending but within strong presumptive limits. A key principle underlying this approach is that the international community needs to set out as clearly as possible the criteria that will govern the size and scope of IMF lending. Another is that decisions on a sovereign's debt are the responsibility of the borrowing country, in consultation with its private sector creditors. The role of the official sector is to ensure that the full menu of financing options is made known and available to the debtor, from which it then chooses. For example, should a country facing severe liquidity pressures decide to suspend payments temporarily then the IMF should be willing to support that decision while remedial policy measures are put in place. Mr King says that this type of framework represents evolution in, rather than revolution of, the international financial architecture. It is also fully consistent with the principles of private sector involvement outlined in the IMFC communiqué in September 2000. The framework Mr King outlines is an attempt to begin to add some operational colour to those overarching principles.

Key Resources

The International Financial System: A New Partnership – Full speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2001/speech138.pdf>