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Addressing the Weaknesses of the International Financial System

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The international financial system is not stable. How serious is this problem? What are its causes? What should be done to improve the system?

Four ratios illustrate how the present crisis is the most severe since the IMF was established: 10 percent; 4 percent; 40 percent and 8 percent. Let me elaborate.

In 2012, global GDP may be 10 percent lower than the level projected before the crisis. It is unlikely that under present policies, this output loss can be recovered in the medium term.

Due to the crisis, in advanced countries there will be an additional 4 percent of the workforce, or 20 million people, unemployed in 2010. Job losses will be even higher because many workers drop out of the workforce or work fewer hours. It is a huge challenge for labor market policies and social policies to help prevent a significant part of this surge in unemployment from becoming long term.

As a result of the crisis, in 2014 gross public debt in advanced G20 countries will be 40 percent of GDP higher than was projected before the crisis. Without new measures, the average gross public debt in the G20 advanced countries will be 118 percent of GDP. However, it is projected that in emerging market G20 countries, the debt stock in 2014 will be 36 percent, broadly unchanged from before the crisis.

The IMF estimates total losses in the financial sector in the advanced countries during the four years 2007–2010 at US$ 3.4 trillion, or about 8 percent of the GDP of those countries[1].

Financial crises are of all times. Since 1945, countries have been cooperating more actively to limit their occurrence and incidence and to create conditions of stability which would be conducive to prosperity. Nonetheless, in the last 30 years or so, crises have tended to be more severe and are transmitted regionally, and even globally, beyond the country of origin.

During the 25 years that the Bretton Woods par value system operated, international capital movements were for the most part restricted. Current account deficits were

[1]US$ 2.8 trillion would be the losses of banks. For U.S. banks, they may approach US$ 1 trillion or a cumulative loss rate on their assets of about 8 percent. For Euro area banks losses are estimated at US$ 800 billion, or a loss rate of about 4 percent of their assets. The balance of the losses would be in the United Kingdom and the rest of Europe. With only about US$ 100 billion, losses of Asian banks would be relatively moderate. These estimates are substantially higher than those by national authorities.

financed with the international reserves of countries concerned or with short-term credit from the IMF. Under those circumstances, external deficits tended to be temporary and limited in size. The exception was the country that issued the reserve currency, the United States, as long as creditor countries did not question its solvency by asking for the conversion of U.S. dollars into gold. This system collapsed in 1971.

From then on, with international capital movements increasingly unrestricted, countries could finance, rather than correct, larger deficits for longer periods of time. If the means of financing was borrowing rather than foreign direct investment, the seeds of a crisis were quickly sown. The international financial system did not become more stable – quite the contrary.

The Latin-American debt crisis of the 80s was a first generation of a new type of crisis. The second – more virulent – generation was in the 90s and early in this decade. The events are still fresh in our memories: Mexico in 1994, several Asian countries in 1997, Russia and Brazil in 1998, followed a few years later by Argentina and Turkey.

Each of these crises erupted because creditors lost confidence in the value of their claims. The trigger was either a tightening of U.S. monetary policy, a political event, the revelation of bad economic news kept secret for a while, collapsing commodity or oil prices, or the transmission of a financial crisis elsewhere in the world. Often, it was a combination of these factors. However, the root cause was always excessive domestic spending, public or private, including poor investment, financed by easily available and seemingly attractive foreign credit. In all instances, large current account deficits were financed with external debt, contracted mostly while neglecting exchange rate risk[2].

After the last emerging market country crisis, in Turkey in 2001, the world had seemingly changed for the better. A period of high, uninterrupted global growth without any major crisis had started. Central banks were highly credible and successful in keeping not only inflation, but also interest rates low. With rising stock and housing prices, consumers were confident. So were investors. Banks provided ample credit against collateral at high valuations rather than on the basis of a careful assessment of future debt service capacity. Many emerging market countries had improved their policies and built up significant amounts of external reserves. In some circles, the IMF was seen as superfluous, without relevant mandate as an institution whose downsizing was overdue.

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[2] The consequences of each of these crises were broadly similar as well. Losses in the domestic banking sector were large, sometimes of the order of 10 to 20 percent of GDP, or even larger. If not left to foreign creditors, these losses were included in the public debt, after shareholders were wiped out. As financing collapsed, so did demand and output. The downturn was always severe, with a commensurate destruction of employment. However, the rebound often came relatively soon as the rest of the world could accommodate export-led growth in the crisis country. In all cases, public debt increased dramatically for a number of reasons: exchange rate losses on public debt in foreign currency (the Asian crisis was a notable exception); the absorption of losses in the banking sector; and the consequences of the fall in economic activity. If public debt did not increase even higher, it was because domestic or foreign financing was simply not available. The IMF, the only major source of financing in these circumstances, imposed strict fiscal discipline, even in the Asian crisis where fiscal excess was clearly not the cause of the problem.

During the period 2002–2007, concerns about a new crisis were largely absent. However, this was not so for the IMF and some circles of policymakers and observers. The growing current account deficit of the United States, and its counterpart surpluses in China and the rest of Asia in particular, were of concern. The Fund repeatedly warned about the risk of a disorderly unwinding of these global imbalances. Reduced willingness by other countries to accumulate claims on the United States would cause sharp dollar depreciation, significant losses for net holders of dollar assets, a severe collapse of global economic activity, and an aggravation of protectionism.

The crisis did occur, but it developed differently. There was no sudden or even gradual withdrawal of foreign credit from the United States. The dollar did not depreciate disruptively. The main financial fall-out of the crisis was not in the net creditors of the United States, China and other Asian countries, but in Europe. What was overlooked by the Fund, and indeed by most other observers?

I am well aware that any backward-looking analysis risks preaching with the benefit of hindsight. The analysis is nonetheless critical for identifying the weaknesses of the international financial system that must be corrected.

By now, there is a vast literature on the causes of the crisis. There is a tendency to stress the mistakes in the private financial sector. The significant shortcomings in prudential regulation and supervision are also highlighted.

In my narrative of the crisis, I would like to stress the fundamental political causes and the perverse incentives created by monetary and fiscal policies and by prudential regulations. In doing so, I should not excuse nor understate the serious mistakes of financial sector managers. Providing credit to borrowers who offer insufficient guarantee of repayment, financing long-term credit with excessive short and volatile funding and circumventing the most fundamental rules of prudential supervision are serious violations of basic rules of sound banking. I will not discuss in detail poor risk management practices, remuneration systems that encouraged excessive risk-taking at the expense of long-term profitability, the flaws of the “originate and distribute” model, the conflicts of interest in the rating agencies and the excessive reliance on external credit assessments. All these shortcomings should be corrected by better corporate governance and indeed binding public regulation.

Rather, I will concentrate on the role of macroeconomic incentives, the traditional core business of the Fund. I will also expand on the shortcomings of prudential regulation, a topic that the Fund left to the competence of other fora, in particular the Financial Stability Forum and the Financial Standard Setting bodies in Basel.

During the last decades, a serious financial crisis had often had roots in a previous crisis.

In the early 90s an asset price bubble burst in Japan. The central bank, with some delay, drastically reduced interest rates to counter deflationary pressures and help revive a crumbling banking sector. Low Japanese interest rates stimulated carry trade – the

acquisition of higher yielding assets financed with cheap yen credit. This short-term volatile credit contributed to overheating in Thailand, Indonesia, Malaysia and Korea, in particular with overinvestment in low productivity assets. In the aftermath of the 1997 Asian crisis, investments in that region of Asia dropped, making excess savings available for financing investment elsewhere, particularly in the United States. The Asian savings glut, and the low interest rate policy of the Fed in response to the global downturn in the wake of the Asian crisis, contributed to yet another asset price bubble, the dot-com bubble. Its bursting in 2001 had relatively mild ramifications for the financial sector, as credit financing of equity investments had been relatively limited. Through wealth effects, its impact on the real economy was nonetheless potentially severe. With inflationary pressures absent, and deflation a risk, the Fed drastically reduced interest rates in the pursuit of its second objective of full employment.

Macroeconomic imbalances in the United States and elsewhere in the world continued to grow. They were not corrected with macroeconomic adjustment. On the contrary, a combination of strong monetary and fiscal stimulus[3] engineered a rapid rebound in U.S. activity and, with it a fertile ground for the present crisis, as lax macroeconomic and macroprudential policies continued.

On a technical level, one can identify at least four main causes of the crisis:

First, monetary and exchange rate policies. In the absence of inflation, the U.S. Federal Reserve deferred monetary tightening. Its loose monetary policy was amplified by key emerging market countries, China in particular, that peg their currencies to the dollar at overly depreciated levels. Japan continued to address its problem through expansionary monetary policy, rather than real sector restructuring. The world became awash with policy-driven primary liquidity, fueling strong asset-price inflation[4].

Second, fiscal policy was, in many instances, pro-cyclical to a larger degree than was estimated in conventional analyses, mainly because of the buoyancy of tax revenues related to soaring asset prices[5].

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[3] The U.S. fiscal deficit widened with 5 percent of GDP in the period 2001—2004.

[4] Already in the September 1999 Board meeting on the World Economic outlook, we warned about the dangers of asset price bubbles and the need for the monetary authorities to have a hands on approach: "*The threat that asset market developments can disrupt macroeconomic stability is serious enough to require that monetary policy try to defuse it. Several past episodes in the United States and elsewhere suggest that focusing wholly on price stability as traditionally understood may lead to suboptimal conduct of monetary policy, and result in serious financial instability. … The risk is that excessive liquidity growth will gradually replace real fundamentals as the main driving force of the boom. …We are concerned that the absence of visible inflationary pressures in the United States may be a curse masquerading as a blessing. …the combination of rapid money growth, stable prices, and high asset prices suggests that present monetary policy may be unintentionally pushing economic activity beyond sustainability into a speculative boom. The experiences of Japan, the Nordic countries, and even the United States itself in the years after 1929 suggest that correcting the excesses of such a boom can be a costly and protracted process."*

[5] IMF, Jaeger and Schuknecht, WP/04/54.

Third, financial innovation was creating market-generated liquidity, thereby supercharging the primary liquidity creation by central banks.

Fourth, regulatory shortcomings failed to rein-in credit-market excesses, particularly in the United States, but also elsewhere.

Most of these failures can be summarized in one observation: the interaction between monetary policy, liquidity creation, asset price behavior, risk taking and financial stability was not fully assessed by most policy makers and supervisors alike.

It comes as no surprise that the epicenter of the crisis is in the largest deficit country of the world – the United States – where credit extension was abused the most. The household sector, without savings in the aggregate, was upholding an unsustainable level of consumption, driven, at least for a while, by ever increasing asset prices, particularly house prices.

Macroeconomic policies and supervision are not conducted in a political vacuum. A significant cause of the disaster we face today is political. It was the inability to better contain the subsidy for the American consumer, who is among the most subsidized in the entire world. Borrowing for housing and consumption is fiscally stimulated as in few other countries. Interest paid on U.S. mortgage loans, even used to finance consumption, are almost entirely deductible for the income tax base. In an environment of rising house prices and stagnating salary levels for most workers, this fiscal incentive to borrow was powerful. During the period 2000 to 2007, the stock of mortgage loans in the United States increased by more than 6 trillion dollars. By 2007, U.S. families had extracted US$ 1.1 trillion of home equity, largely to finance consumption with loans, the interest of which is tax deductible.

There is also quasi-fiscal subsidization in the United States. Public policies instructed or condoned that Fannie May and Freddie Mac, government-sponsored enterprises operating under the *de facto* guarantee of the U.S. Treasury, gave ever more risky credits to the common household on terms unsustainable for the borrower and, as proved in 2008, at risk to the public finances.

Finally, it will probably never be clear to what extent lax U.S. prudential supervision should be explained by negligence, ideology or reluctance to cause significant political and social problems if stricter housing credit policy had curbed what seemed in many respects to be an economic and political success.

In some sense, the subprime and other subsidized and risky mortgage loans were the political response to make ever more expensive housing still affordable for the common people with stagnating labor income[6]. In this respect also, the present financial crisis in the United States is similar to earlier crises in many emerging market countries:

[6] Kemal Dervis highlights the growing income inequality as two-thirds of all economic gains in the U.S. during the pre-crisis growth accrued to only 1 percent of the population. Rapid growth nonetheless occurred as U.S. households accumulated unsustainable debt in the illusion of wealth created by asset price bubbles (The Per Jacobsen lecture, Istanbul 2009).

consumption, investment in housing, and public spending could not be limited to what was financially affordable. This explains why the Fund was not more effective in convincing the authorities to adopt politically difficult corrections.

As I said earlier, the IMF had warned of a U.S. centered crisis. However, why did the crisis develop differently from what the Fund had warned of?

The short answer is that the Fund predicted a more traditional type of balance of payments crisis. That the United States is the country issuing the reserve currency was overlooked. The approach was a traditional macroeconomic analysis. The build-up of risks in the financial sector and their effects on macrostability were not analyzed well enough, or at least not forcefully communicated to national authorities. Financial innovation obscured the picture. The increasingly skewed income distribution in the United States, and its consequences for credit risk were largely overlooked and require more research. The Fund's concerns about global imbalances focused on current account deficits and surpluses. International capital flows, which are a multiple of current account imbalances, and the fast growing stocks of cross-border assets and liabilities remained insufficiently documented and analyzed as a channel of international transmission of a financial crisis.

Emerging markets generally finance their current account deficits with foreign currency loans. A sharp depreciation of their domestic currency risks making their debt unsustainable. The prospect of such devaluation therefore often becomes a self-fulfilling prophecy when foreign credit is suddenly reversed. In emerging market countries, the crisis starts with a balance of payments crisis and a currency crisis, which then spills over into a financial sector crisis.

In the reserve currency country, the crisis dynamic is different. There is no balance of payments or currency crisis, but directly a financial sector crisis. Unlike periphery countries, the reserve currency country does not contract debt in foreign currency. A significant dollar devaluation, in and by itself, does not make U.S. debt unsustainable. Moreover, the United States holds sizable foreign direct investments and portfolio investments expressed in other currencies, equivalent to 70 percent of GDP in 2007. For the United States, a devaluation of the dollar improves its net (International Investment Position) IIP. This helps explain why, notwithstanding a high cumulative current account deficit, the U.S. negative IIP in 2007 was moderate at only 15 percent of GDP. It was comparable with the 14 percent of GDP negative IIP of the Euro Area. The large demand for international reserve assets from emerging countries in Asia and from oil producers, when no other country was offering high-quality assets in sufficient amounts, assured the U.S. financing for its growing deficits without a sudden reversal or even gradual reduction of foreign credit. Being the reserve currency country helped in preserving creditor confidence. The traditional macro analysis of the U.S. IIP explains the benign assessment of U.S. country risk. At the same time, domestic and foreign creditors, and the United States and international supervisors overlooked domestic credit risk at the micro level and its threat for macro financial stability. The absence of effective market discipline and of more precise warnings from the international surveillance process

weakened incentives for the U.S. authorities to correct the distortions and excesses in the U.S. economy.

The collapse of market discipline can be further explained by the traditional high credit rating that foreign investors require for their investment, the alchemy of financial innovation and moral hazard, the belief that, in a situation of systemic danger, public authorities will protect creditors against losses.

Central banks and many other foreign investors expect their U.S. investments to be liquid and highly rated. In the aggregate, this was difficult to match with the credit needs of end borrowers in the United States. Households in particular, needed long-term credit but offered lower or even substandard credit standing. To bridge this gap between the characteristics of credit supply and demand, a huge maturity transformation and credit risk was taken on the balance sheet of the financial sector in the United States but also, as we will see, in Europe. It is here that the financial innovation was used to create, out of long-term substandard loans, seemingly highly liquid assets of the highest credit quality.

The complexities of financial innovation and high asset evaluations seriously complicated a proper assessment of the nature and size of this liquidity and credit risk. In an environment of low interest rates and a search for higher yield, developments in the financial sector went ahead of prudential regulation. Serious loopholes in financial regulation enabled a poorly monitored explosion of credit and a sharp increase of leverage in the financial sector.

For today, I would like to single out two regulatory failures that stand out: gaps in the scope of financial regulation and ineffective macroprudential regulation and supervision.

New types of financial institutions with very large operations were not regulated or supervised. Regulatory regimes for different types of financial institutions were not coherent. This was a fertile ground for regulatory arbitrage with innovative transactions and structures in the so-called shadow financial sector. Capital adequacy rules for banks were circumvented. Most innovations are risk-transfer mechanisms: off the balance sheet and back to the balance sheets of banks. Selling securitized assets to separate legal entities –the now infamous “conduits and Structured Investment Vehicles (SIVs)”- significantly lowered capital adequacy requirements. Credit lines for conduits and credit enhancements linked the securitized loans back to the balance sheet, but at a considerably lower capital adequacy requirement. Credit enhancements for securitized claims were also provided by other financial institutions, in particular monoline insurers and “financial products” providers. These non-bank financial entities could underwrite credit risks with no or much lower capital requirement than applicable for banks that maintain credit risk on their balance sheet. [7] [8]

[7] In its Spring 2004 Global Financial Stability Report, the staff of the Fund, while generally positive about the financial innovations to transfer risks away from banks’ balance sheets, nonetheless raised pointed questions about their potential dangers and still poorly understood aspects.

"One of the most important changes in recent years has been the transfer of risk—in particular credit risk—from the banking sector to the nonbanking sectors of the financial system and beyond. So far, this

These financial innovations freed substantial amounts of capital for new lending, generally of lower quality. In the end, leverage in the banking sector increased, particularly in the largest and most sophisticated international banking groups.

Slide 2 shows how in ten large international banks, risk weighted assets increased from US$ 4 trillion to US$ 5 trillion in the period 2004 to 2007. This is an approximation, according to prudential rules, of the risk against which a bank must hold at least 8 percent capital. However, in the same period, the total amount of assets on which losses could occur, increased from US$ 8 trillion to US$ 16 trillion. This implied a very substantial reduction in required capital adequacy, a development which banks have used to significantly increase leverage. The second graph shows how much more extreme the situation was for European banks, compared to U.S. banks. One factor is that since 1999, unlike Europe, the United States had closed some loopholes in the capital adequacy framework with respect to securitization. However, derivative loopholes remained in both jurisdictions.

The next two graphs show how new accounting rules under IFRS, in accordance with the economic reality principle, had brought back to the balance sheet significant amounts of assets considered before as off balance sheet. Nevertheless, capital adequacy regulation remained unchanged for a few more years.

The next graph on the right illustrates how, in just four years, the Tier 1 to Total Assets ratio dropped from 3.8 to less than 3. This is a dramatic increase in leverage. The graph also shows how leverage in European banks, on average, is twice that in U.S. banks.

In conclusion, the Basel I capital adequacy framework, under which the crisis developed, no longer captured economic reality properly. The introduction of new accounting rules

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phenomenon ….. meant a transfer of credit risk from relatively more regulated institutions to relatively less regulated institutions and from relatively more transparent institutions to relatively less transparent institutions. The transfer of risk to nonbanking sectors has therefore raised several concerns: Where has the risk gone? Has risk been widely dispersed or concentrated? Are the recipients of risk able to manage the risk they have assumed? Given all the changes, is there the potential for regulatory arbitrage? Inconsistencies and gaps in regulation and supervision could create strong incentives and the temptation to exploit such shortcomings. "

[8] In the April 2005 Board discussion on the global financial stability, we observed:
"*The biggest conundrum on potential systemic threats is whether and to what extent financial innovation could have a destabilizing impact …. The dramatic growth of derivatives markets and, especially, over-the-counter derivatives in which financial institutions deal with each other directly rather than through public markets (is a cause for concern) ….. The degree of concentration in these (derivative) markets is enormous. …Despite the positive feature of credit derivatives in terms of risk transfer, with so much market concentration, the risk to reduce bank exposure in the face of a possible shock could magnify rather than diminish the shock."*

made this only more transparent. Equally dangerous, a number of systemically important financial institutions could operate outside its coverage[9]

The second major shortcoming of which the crisis has reminded us, once more, is the need for better macro-prudential regulation and supervision. It does not suffice to monitor the strength and financial health of individual institutions to ensure stability of the financial sector as a whole. Macroeconomic shocks and distortions can severely affect even the best managed financial institutions. There is long experience about this from the capital account crises in the nineties but, unfortunately, short memory.

Before I expand on the needed regime changes, I should illustrate how international capital movements and cross border holdings transmitted the crisis in the U.S. differently from what was expected.

The international debate prior to the onset of the crisis had been focused on the current account imbalances and the risks for net holders of dollar assets. However, it is gross international capital flows, which are a multiple of current account imbalances, and the fast growing stocks of cross-border assets and liabilities, that explain the international transmission of the crisis.

We should nonetheless start with a short review of global imbalances.

Slide 5 shows the steady increase of current account imbalances from less than 1 percent of global GDP after the Asian crisis to almost 3 percent in 2007, by then US$ 1.6 trillion. In addition to the United States, the only other significant deficit region in the world is part of Europe: the U.K., the Mediterranean Euro area and Central Europe. At the global level, China became a significant surplus country in 2005. However, surplus Europe, Germany, the Nordic countries, the Benelux, Austria and Switzerland constitute the most important surplus region in the world.

Slides 6 and 7 show how gross annual capital outflows and inflows have increased in tandem with the growing global imbalances, but are a significant multiple of the amount of current account imbalances. In 2007, they reached 18 percent of world GDP or about US$10 trillion.

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[9] A lot of damage could have been avoided if these loopholes in prudential regulation were closed soon after 1999. In that year, the G7 established the Financial Stability Forum on the basis of a report by Mr. Tietmeyer, then the President of the Bundesbank. This report was visionary in identifying areas where action was needed. Mr. Tietmeyer insisted on improving in-house risk management of financial institutions. He stressed the need for appropriate transparency and disclosure for all market participants. He asked that significant information gaps for supervisors be closed and that information be better shared at a national and international level among all relevant authorities and international institutions. Most important, the Bundesbank President called for closing gaps in regulatory standards and applying rules consistently at the international level and across all types of significant institutions. He also asked that the need for the regulation of non regulated entities be urgently assessed. In short, regulatory arbitrage, internationally and among different types of financial institutions, some of which not yet regulated, needed to be curbed and avoided as a matter of urgency.

Slide 8 - The stock of cross-border holdings is yet another multiple of the annual gross flows and, prior to the crisis, reached US$ 90 trillion, or 1.6 times the world GDP. Fifteen percent of these cross-border holdings are transparently located in emerging and developing countries; the lion's share of about 75 percent in advanced countries and 9 percent in offshore financial centers. However, the ultimate holders of cross-border assets are far from clear, as financial centers, offshore as well as onshore, do not report for which investors they are fiduciary holders.

Slides 9 and 10 show the dramatic increase in the last ten years of cross-border debt assets and liabilities of advanced countries. In the case of emerging market countries, international financial integration measured as the ratio of debt instruments to GDP, did not increase. Stocks of foreign direct investment increased equally, also in emerging market countries.

Slide 11 details the net International Investment Positions of different regions. Observe how the positions of the United States and the Euro area are already similar.

Slide 13 is a breakdown of the U.S. IIP. Net external debt is largely negative (35 percent of GDP) while FDI and portfolio investments are positive, of the order of 20 percent. This graph does not show the U.S. gross position in each category of cross-border holdings. The most important one is a 70 percent of GDP FDI and portfolio investment abroad, offset by a 50 percent of GDP inward FDI and portfolio investment. As the dollar devalues, the exchange rate gains for the United States on its 70 percent outward FDI and portfolio investment are significant.

In conclusion, the United States does not only borrow to finance its excess consumption and investment at home. With active investment bankers, U.S. investors have massively borrowed from foreigners in their own currency to invest abroad in equity.

Slide 14 - Foreign lenders to the United States mainly purchase U.S. bonds. In 2006 and the first half of 2007, the annual amount was well over a trillion dollars, primarily in corporate bonds (the red bars), and a significant part in agency bonds (the yellow bars) which was the implicit government-guaranteed financing of U.S. housing loans. During the height of the crisis, investment in government bonds was the only lending vehicle, with significant foreign selling of corporate and agency bonds.

Slide 15 details the composition of the U.S. bond portfolios of advanced and emerging developing countries. It is striking how the portfolio of emerging market countries is predominantly invested in government and government-guaranteed paper. The share of mortgage-backed securities in their portfolio is marginal.

For advanced countries and offshore centers, the risk profile of the bond portfolio is clearly higher and includes 94 percent of foreign holdings of mortgage-backed securities.

Slides 16 and 17 detail the holdings of U.S. asset-backed securities. They explain why the spillover from so-called toxic assets from the U.S. was predominantly into Europe and not into emerging markets.

Slide 18 shows how, since the Asian crisis, emerging Asia became a net creditor in debt instruments, and a growing destination for FDI and portfolio investments. A similar development can be observed in Latin America (slide 19) in early 2002. For emerging Europe (slide 20), net external debt remained substantial but fairly constant in the order of 15 percent of GDP. Individual country circumstances however do differ significantly, which is often overlooked.

The significant shifts in the cross-border holdings and liabilities of emerging markets have protected these countries against a more severe spillover.

The flight of capital out of emerging markets was significant and their exchange rates dropped. However, ample international reserves provided solid cushions. The IMF has also lent substantial amounts where this was necessary, 90 percent of it in Central Europe. However, contrary to a widespread perception, actual IMF loan disbursements have been relatively limited: in 2008, US$ 21 billion and until October of this year, US$ 25 billion. This is less than the annual disbursements during the Asian crisis or in the period 2001 – 2003, when the Fund disbursed more than US$ 100 billion, converted at today's exchange rates.

In the aggregate, the crisis did not severely affect the creditworthiness of emerging markets. Slide 21 shows how, unlike in the past, currency devaluations in emerging markets improved their International Investment Positions.

I should sound a clear warning. A comfortable IIP or a country's ample international reserves are not a good protection against credit risks on private agents in those countries. Moral hazard and the expectation that the government will bail out private banks and corporates explain the substantial losses for foreign creditors in countries with large external reserves such as Russia, Kazakhstan and, as shown recently, Dubai, part of the United Arab Emirates. IMF credit in such circumstances may not be necessarily helpful.

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How can we make the international financial system more stable? By identifying the present weaknesses in some detail, we have advanced in identifying the necessary future corrections. I distinguish three broad categories: (i) avoid today's crisis from becoming a fertile ground for the next crisis; (ii) countries must correct existing distortions and avoid the emergence of new ones; and (iii) international cooperation must be enhanced urgently and adjusted to the reality of a world economy driven by international capital flows. A timely exit from the extraordinary fiscal, monetary and financial sector support measures is critical.[10]

[10] See Cottarelli and Viñals, "A strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies" IMF Staff Position Note 09/22.

The Fund's recommendations were broadly endorsed during the recent meetings in Istanbul and the G20 Ministerial Meeting in St. Andrews. I summarize them in six points:

1. It is too early to withdraw expansionary macroeconomic policies. Sustain fiscal stimulus until the recovery is on a firmer footing.

2. Commit soon and credibly to large reductions in fiscal deficits, to be implemented, once the recovery is on a more solid footing. In many countries, this requires reform of social security entitlements. Enhance the credibility of such fiscal policy by adopting fiscal rules and enforcement mechanisms to control spending when good times return.

3. Central Banks can afford to maintain accommodative conditions for an extended period because inflation is likely to remain subdued as long as output gaps remain wide. Fiscal withdrawal should come first. Monetary policy will need to accommodate the impact of the gradual withdrawal of fiscal support.

4. In emerging markets, the appropriate moment for starting monetary tightening is likely to be sooner than in advanced economies. A decoupling of monetary policies creates the risks of stimulating carry trade and new asset bubbles. Therefore, greater exchange rate flexibility, particularly in China, is needed.

5. The pace at which the size of central banks balance sheets is reduced would depend on the progress in normalizing financial market conditions.

6. The exit strategy from public support for the financial sector must be clearly articulated to guide markets. It must be gradual and use market-based incentives.

The most challenging part will be the strategy to reverse the fiscal debt dynamics. In many advanced countries, public debt has or will soon reach levels where the snowball effect operates. Fund experts have presented scenarios for individual countries to reduce the public debt stock to 60 percent by 2030. On average, advanced countries must gradually improve their primary structural fiscal balance by almost 5 percent by 2020, and then maintain a substantial primary surplus during the next ten years. For Belgium, the required adjustment until 2020 is 5.6 percent. For the following ten years, a primary surplus of more than 5 percent should be maintained, as shown in slide 23. Under such a fiscal adjustment scenario, engineering satisfactory growth and increasing employment and productivity will require far reaching structural reforms.

Significant macroeconomic distortions in major countries must still be addressed comprehensively. The recent narrowing in global imbalances may only be temporary, unless both deficit and surplus countries adjust. The United States in particular must reduce incentives for excessive borrowing by households and organize a steadfast reduction of its fiscal deficit. Deficit countries in the Euro zone must rebuild competitiveness while adjusting large fiscal deficits. In an environment of low inflation, when differentials in nominal wage growth are very small, this will be challenging, particularly if preserving employment is a political and social imperative.

An upward adjustment of the renminbi is a critical component of the strategy to rebalance the world economy and to avoid employment destruction in Europe if the Euro would further appreciate.

A more flexible exchange rate regime for the renminbi is only part of a comprehensive strategy to replace over time export demand by domestic demand. Additional reforms to improve health care, education and pensions would lower precautionary swaps. China also needs to make progress with credit allocations on a market rather than administrative basis. Significant state aid is indeed a potential for significant distortion in global trade, and emergence of global over-capacity in certain manufacturing sectors. China could use part of its large external reserves to finance productive investments in developing countries, rather than subsidizing American consumers with low-cost credit.

Weak macrofinancial supervision was a major cause of the crisis.

The staff of the Fund suggests that the mandate of central banks should be both price stability and macro-financial stability. This is a sensible proposal on which there is broad agreement, but no consensus in the Board. However, there is widespread agreement that low interest rates affect risk taking but also that the monetary policy interest rate is a poor tool to deal with excess leverage, excessive risk taking and apparent deviations of asset prices from fundamentals. Using regulation to directly affect risk behavior would be more effective. Coordination between monetary policy and macro prudential regulation and supervision is essential. It is advisable that the central bank be in charge of both mandates. The past trend toward separation of the two functions is clearly reversing.

Repair of the financial system and prudential regulatory reform are major priorities in achieving both a lasting recovery and stability. The Fund strongly advises to avoid the mistakes of the protracted banking sector clean up in Japan in the nineties. Banks must, when necessary, recapitalize or restructure, in order to be able to support the recovery.

The Fund insists on more clarity on new capital regulation, liquidity requirements, provisioning and accounting standards. The perimeter of regulation must be broadened and made more flexible to cover all systemic institutions. Market discipline must be enhanced through greater disclosure and reform of governance in financial institutions. Macroprudential frameworks must induce banks to build more buffers in good times, thereby making the financial sector behavior less pro-cyclical. Collaboration to deal with cross-border institutions must improve.

The Fund has been asked by the G20 to formulate proposals to levy a tax on systemic banks in order for them to contribute to the costs of public interventions to avoid financial system collapse. This is an issue on which there is little research so far. Fund staff will have to formulate both innovative and workable solutions, possibly within an international burden-sharing mechanism. There is a clear trade-off between strict regulation, increasing the possibility to involve creditors in the orderly resolution of systemic bank failures and the cost for the public sector, and thus for viable financial institutions to pay for state interventions to avert a systemic collapse.

How should the IMF adjust?

According to Article I of its Articles of Agreement, the IMF is the primary institution offering a permanent framework for international financial cooperation. By becoming a member, countries commit to such cooperation within the institution, not outside. The functioning of the Financial Stability Board and the G20 process should be conform this principle. I will come back to this.

Essential to the Fund is its surveillance mandate. Member countries agree to conduct their policies, as outlined in the well-known Article IV, to promote exchange rate stability. With today's integrated financial system and massive international capital flows and cross border holdings, this should be interpreted as a commitment to promote international financial stability.

Accepting the IMF's surveillance mandate, which is a binding commitment under international law, implies cooperation with an international politically independent staff of experts of which the Managing Director of the IMF is the head. Their task is to document objectively the economic situation and policies of each member state, and how it may affect conditions necessary for harmonious balanced economic developments internationally.

One of the weaknesses of the governance of the Fund is that member countries, through the Executive Board, tightly control how the Fund interprets the scope and conduct of surveillance. That interpretation today is too narrow and no longer consistent with a capital driven world economy.

In the nineties, in response to the capital account crises, Michel Camdessus, the then Managing Director of the Fund, had proposed that the Fund would conduct in-depth assessments of countries' financial sectors. FSAPs would have two components: (a) a fact-finding report about the compliance of the country with international financial sector standards, such as the Basel Core Principles for Prudential Supervision of banks. The second more important part would be assessing how macroeconomic developments could become a threat to the stability of a financial institution and vice-versa, and how developments in the financial sector could undermine macrofinancial stability. The Board however refused to consider such examinations as an integral part of the Fund's surveillance mandate. Countries remained free whether or not to ask the Fund to conduct such assessments. The United States only recently agreed to such an assessment, which is now ongoing.

It may surprise many of you that, even last summer, when the Board revisited the issue, no majority could be found to change the prevailing interpretation. Accepting this "fait accompli" would be a major surrender for all countries committed to multilateral cooperation to preserve financial stability.

On the proposal of the Managing Director, the IMFC, during the ministerial meeting in Istanbul last October, agreed that the Board should review, once more, the mandate of the

Fund, including in particular, macrofinancial stability issues, as an integral part of Fund surveillance.

For more than ten years, we have strongly supported such progress. I hope we will succeed in the coming months.

Member countries have limited the Fund's activity in the domain of financial sector stability in other ways. In 1999, the G7 established the Financial Stability Forum (FSF). Its purpose is to agree on financial regulation issues among the major financial center countries. As I mentioned earlier, the Tietmeyer report was visionary in identifying the weaknesses that needed to be addressed. The follow-up was not perfect.

The FSF has recently been transformed to the Financial Stability Board (FSB) and its membership has been expanded to include all G20 countries. This cooperation is important. However, its governance structure should be improved by including the functioning of the FSB in the overarching framework of the IMF.

The IMF has no decision-making power to adopt binding international prudential regulation for the financial sector. It is very doubtful that countries will surrender, any time soon, their sovereignty to an international body in this domain. However, it would be real progress if countries accept that their process of cooperation is permanent, will not be interrupted, and is guided and informed by an internationally independent expert staff. An essential responsibility of the IMF staff should be to identify weaknesses in the existing regulatory framework and promote action. However, the decision-making power on what action to take would remain with national governments. The composition of this Financial Stability Board, as part of the IMF, would be different and distinct from the Executive Board. Care should be taken that all member countries are included in the process, through a constituency structure, without endangering the efficiency of the cooperation. Such constituencies could be different from those in the Executive Board.

The effectiveness of IMF surveillance relies on the high quality of the technical reports, their real and perceived impartiality, and their pragmatism in proposing ways for policy makers to pursue often difficult policies with a high degree of ambition. Above all, IMF surveillance must instill a peer pressure among authorities to adhere to policies beneficial for achieving common goals. The discussions in the Executive Board of the IMF are not fully effective. Authorities with decision-making power should be more actively involved.

With that aim, a few years ago, the IMF experimented with a first "multilateral consultation". The Ministers of Finance and Governors of the Central Banks of China, the Euro area, Japan, Saudi Arabia and the United States were invited to discuss among themselves, and with the participation of the staff, how to gradually reduce global imbalances while preserving continued growth. The process was innovative and potentially promising. It was launched on a purely voluntary basis. The results were not successful as all partners were too defensive of their own policy strategies.

At the Pittsburgh Summit, the G20 decided to initiate a similar "cooperative process of mutual assessment of G20 country policy frameworks and the implications of those frameworks for the pattern and sustainability of global growth." Based on the results of this mutual assessment, the G20 will consider and agree on actions to meet common objectives. The IMF has been asked to assist in this process by developing a forward-looking analysis of whether individual country programs are internally coherent and are collectively consistent. This process was clarified in greater detail at the G20 Ministerial meeting in St Andrews.

Achieving a better follow-up of IMF surveillance through the G20 peer review would be an extremely positive development for the Fund. The G20 insist that the process is not a Fund but an internally driven process. The Board will clarify in the coming weeks how the G20 mutual assessment relates to bilateral and multilateral Fund surveillance. The Fund should encourage the G20 to pursue their process, with technical involvement of Fund staff. However, the Fund's surveillance should remain the basis and a critical input for this new style of multilateral surveillance. The Fund should not relinquish its authority to invite relevant countries to participate, in a mandatory manner, in a multilateral consultation process. The Executive Board of the Fund should ensure the independence of the staff in its technical impartial analysis and recommendations. The Board's involvement remains useful to ensure proper information and involvement of all Fund members, and promote quality and evenhandedness of the staff's analysis. It would be a significant step backward in multilateral global cooperation, if a subset of countries –important as they are– would marginalize the role of the Fund. To the extent that the G20 and the Financial Stability Board have an ambition beyond mutual consultation, their functioning should not be allowed to shift international financial policy cooperation on a global level outside the IMF.

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Fund financing remains an important tool to help manage international financial crises. It helps avoid disruptive volatility of exchange rates and cushions economic downturns in the country that is directly affected, and its trading and financial partner countries.

Recently, the Fund has made its lending policy more flexible to ensure, to the extent possible, that spill-overs from one emerging market country crisis to other countries and their banking sectors, would be avoided. An innovative new type of credit is now available. Countries with strong policy records can receive a Fund credit line without ex post policy conditionality. For them, the Fund is confident that their policy will remain strong, and will be adjusted as necessary.

A Flexible Credit Line (FCL) allows a country to call on the Fund, at any time, for immediate disbursement of a significant amount of money. Mexico, Poland, and Colombia have received such a credit line for a total amount of US$ 83 billion. The announcement of the FCL for these countries had a significant effect on market confidence, as shown in the narrowing of risk spreads.

Substantial additional lending resources for the Fund in the order of US$ 600 billion, and the allocation of SDR 250 billion, which was announced at the London Summit of the G20, has also been highly instrumental in enhancing confidence in financial markets.

In Istanbul, the IMFC asked the Board to examine whether the existing lending instruments of the Fund should be further improved and how the Fund could offer credible alternatives for the tendency of emerging market countries to build up very large international reserve stocks.

A constructive approach must frame this demand in a broader context of the functioning of the International Monetary System. The system is now overly dependent on one major reserve currency. Building major dollar reserves outside the United States requires that, in practice, the United States runs more or less permanent current account deficits, ideally in combination with fiscal deficits to provide high quality assets to foreign central banks. A tendency by emerging market countries to hoard large, if not excessive, international reserves, in part as a precaution against international shocks, prolongs and deepens imbalances in the world economy, making it prone to financial crises. There is little recent research on this topic and on the role of the financial sector for intermediating huge capital flows between central banks as holders of international reserves and final borrowers in deficit countries. In this process, the financial sector may absorb significant maturity and credit risks in the system. To what extent central banks and the IMF should provide a backstop when these risks materialize will be the central issue when the Board reviews these topics in the coming months.

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Governance issues at the IMF have been the center of attention for a number of years. This is a sign of persistent tension and lack of a genuine multilateral spirit.

Strengthening the independence of the staff and the Managing Director should, in my view, be a primary objective. Developing countries and many observers perceive the Fund as an institution that is too much guided by the narrow interests of the largest shareholders who control the appointment process of the MD. Even if such perception is wrong, it is damaging for the Fund's credibility. A selection process for the Managing Director that is merit-based and irrespective of nationality, is essential to enhance the Fund’s general acceptance and standing. Agreements in principle on this have been reached. They should be adhered to in good faith.

The voting power of countries in the Fund should be fairly distributed, according to an agreed formula for measuring the economic relevance of each country, in relation to issues for which the Fund has a mandate.

Three years ago, the Board agreed on a new formula. This formula is far from perfect. The economic weight of countries is measured in terms of GDP, trade flows and international reserves. However, other cross-border holdings, which are now a major part of a country's international investment position, continue to be neglected.

At the Pittsburgh summit, after difficult negotiations, the G20 agreed to a shift in quotas towards dynamic emerging markets and developing countries of at least 5 percent from overrepresented countries to underrepresented countries. The exact interpretation of this political agreement remains somewhat unclear and disputed. However, it seems likely that this deal will result in a significant increase of voting power for underrepresented emerging countries, in particular China, Turkey, and Korea. China's quota will most likely become equal to that of Germany, but it will remain below that of Japan. China would then become the third or fourth largest shareholder of the Fund.

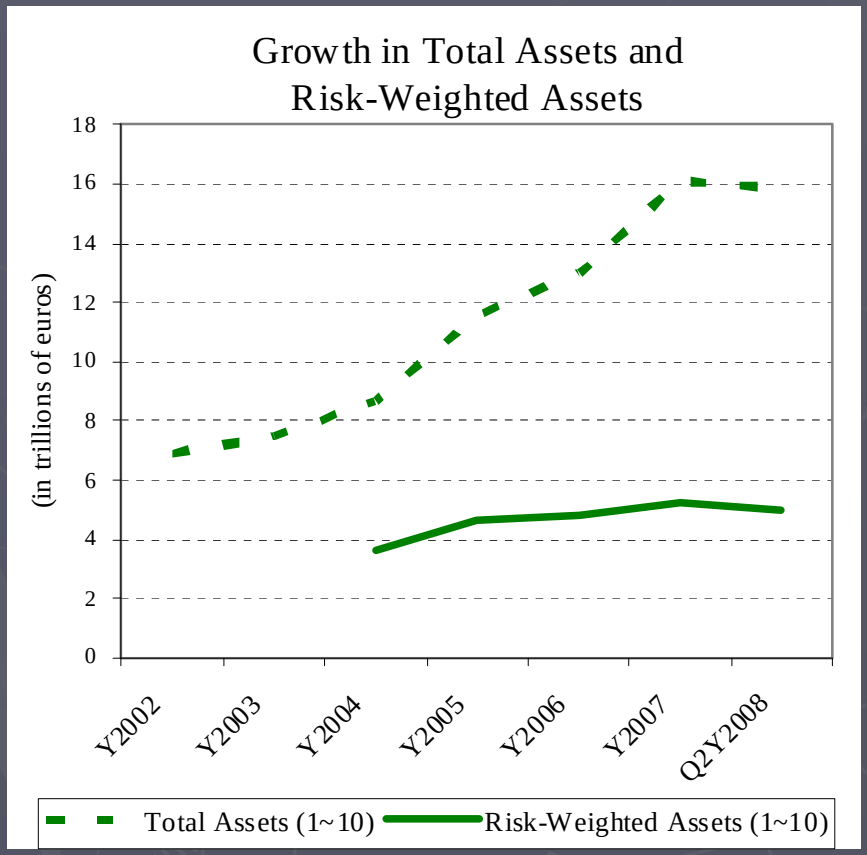
Belgium's quota may decline more than marginally. However, within our constituency, Belgium's quota will remain the largest, with a significant margin over our two main partners, Austria and Turkey. As a whole, our ten-country constituency will see its quota share increase further. At the informal EU Council, in preparation of the Pittsburg summit, European leaders agreed that the present number of 24 Executive Directors is a good balance between the need for representation of all member countries and the effectiveness of the Board. If other countries, particularly the United States, agree with this view, the mixed European constituencies, led by Belgium, the Netherlands, Sweden and Switzerland should continue to contribute to the functioning of the IMF, in a true multilateral spirit, to help the Fund pursue its objectives of financial stability, balanced global growth, and employment opportunities for people everywhere. The founders of the IMF were critically aware that those objectives were essential for preserving harmonious international political relations and peace.

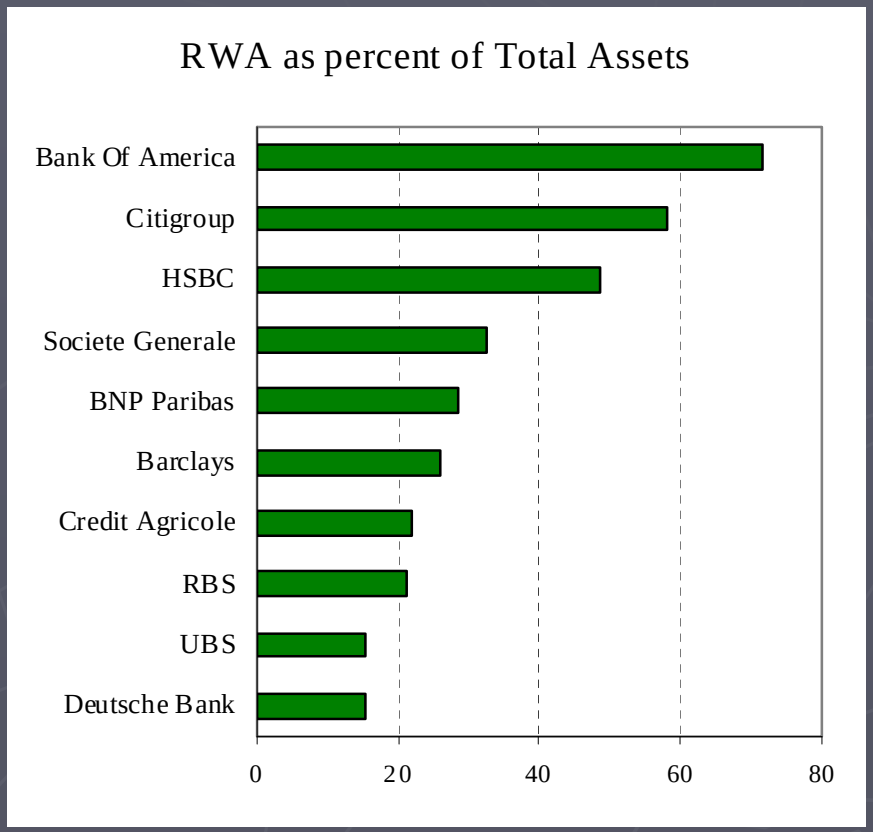
Addressing the Weaknesses of the International Financial System

Willy Kiekens

December 7, 2009

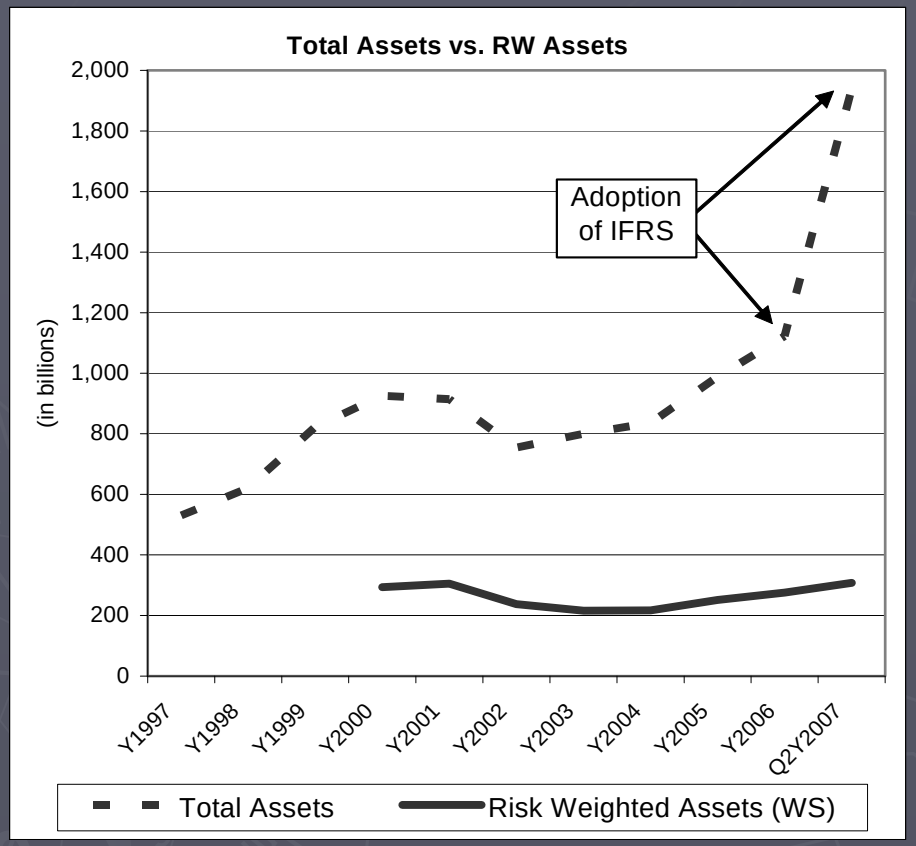
Total Assets vs. Risk Weighted Assets





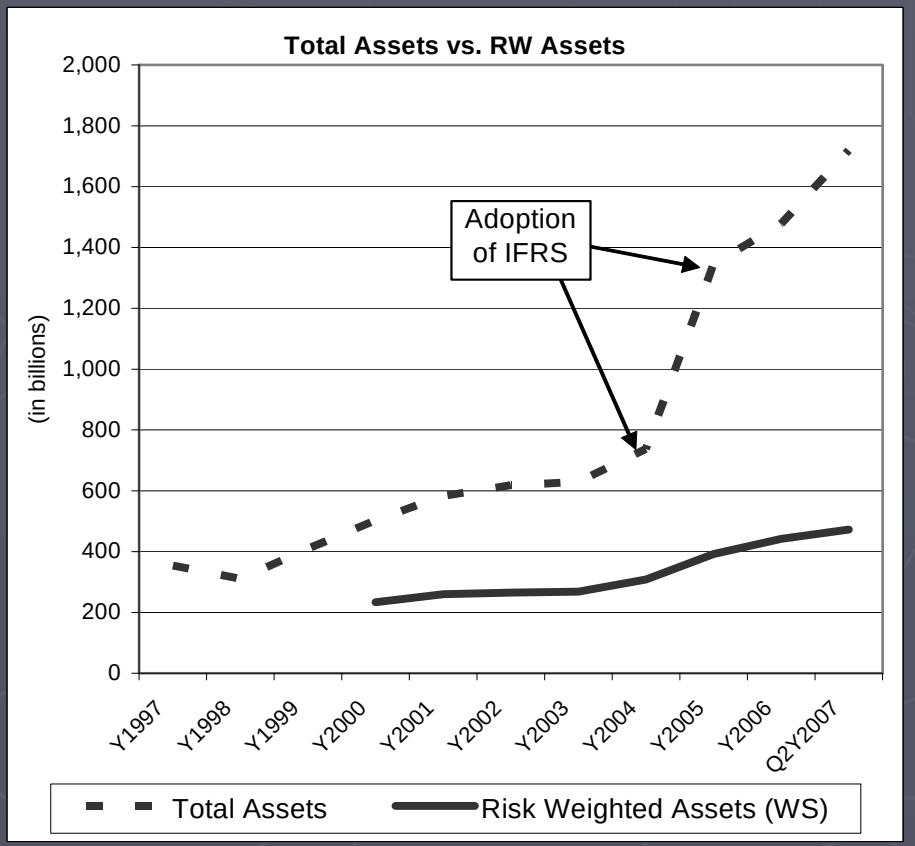
Total Assets vs. Risk Weighted Assets

DEUTSCHE BANK AKTIENGESELLSCHAFT



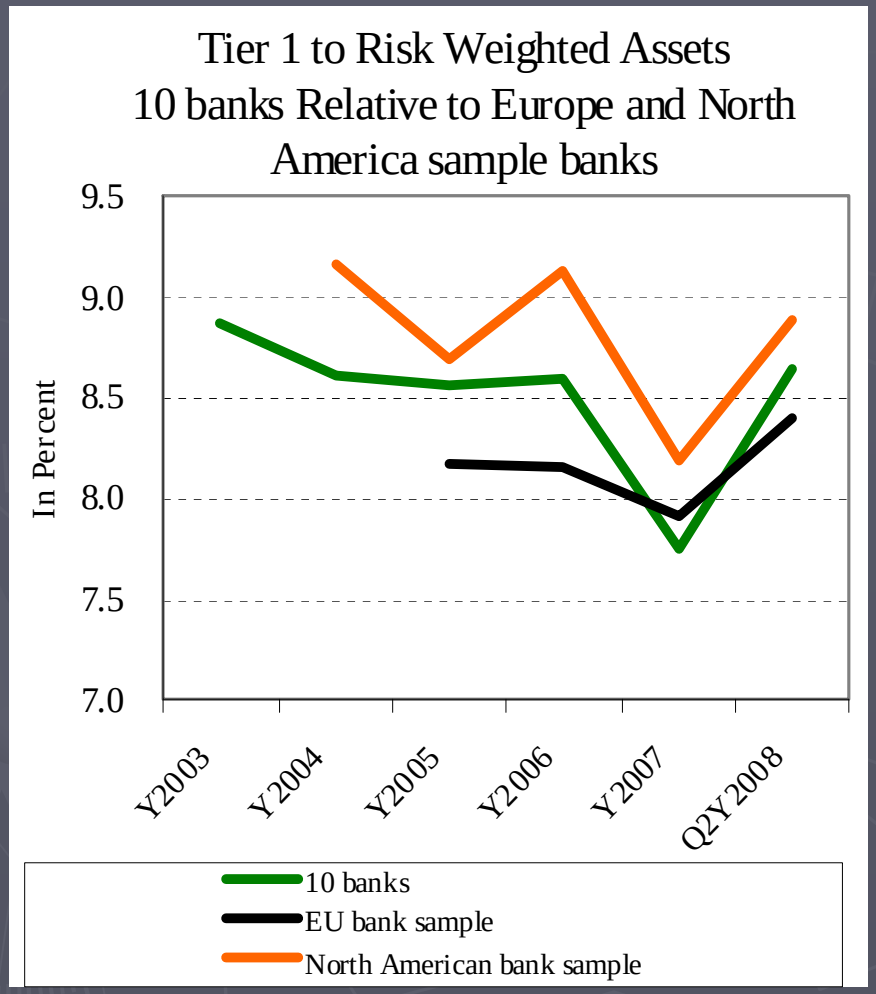
Currency EUR

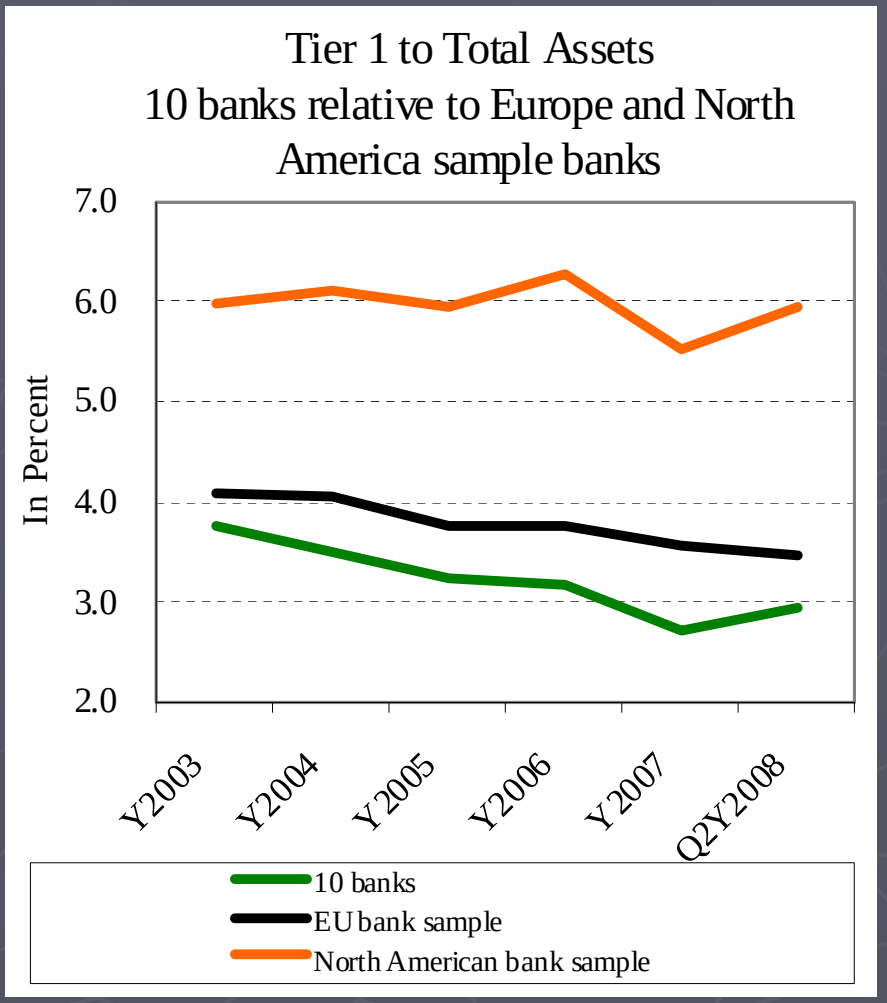
BARCLAYS PLC



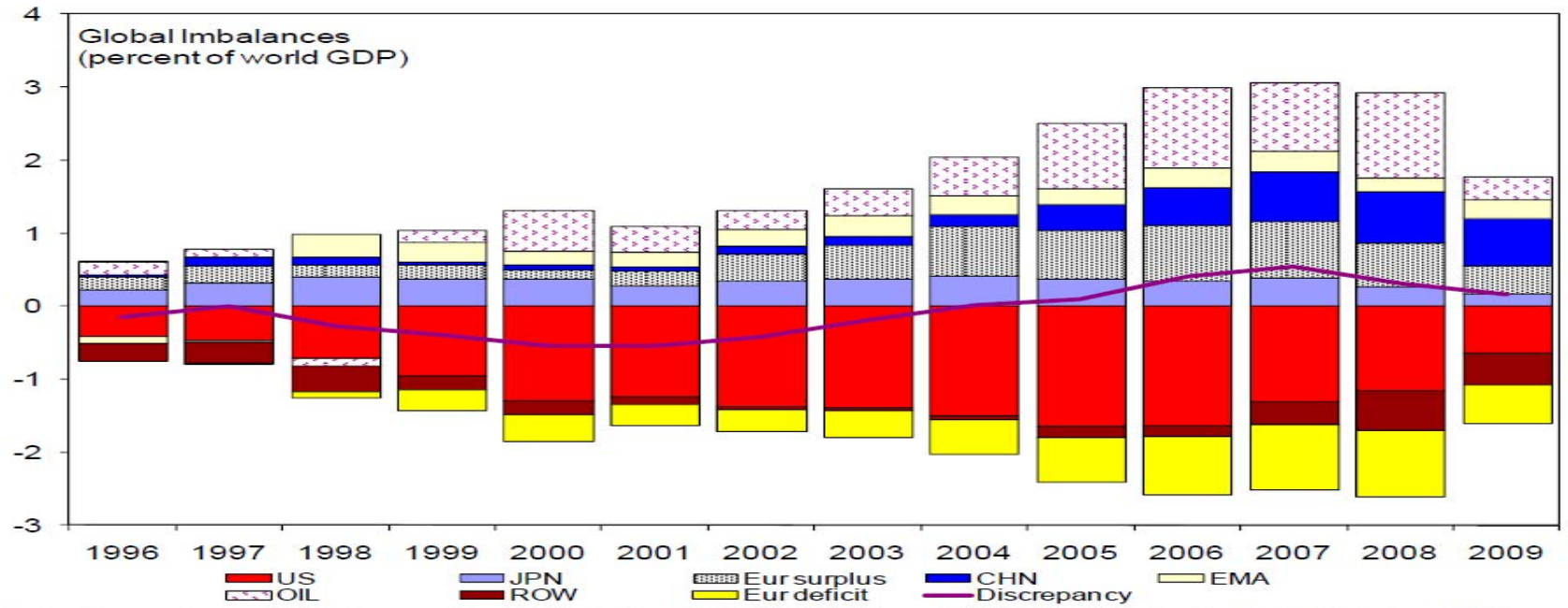
Currency EUR

Capital and Solvency Ratios





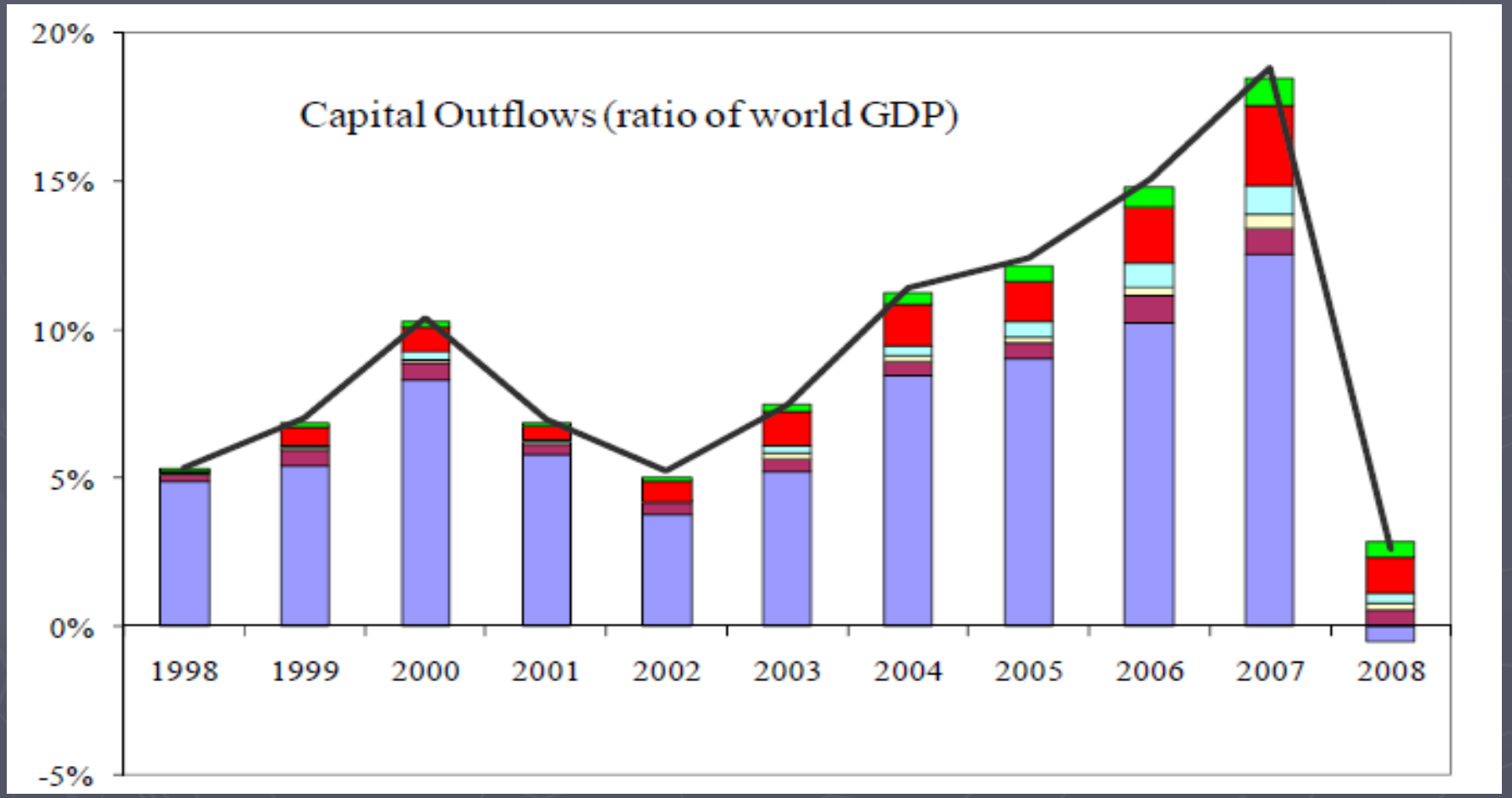
Global Imbalances 1996-2009
(in percent of World GDP)



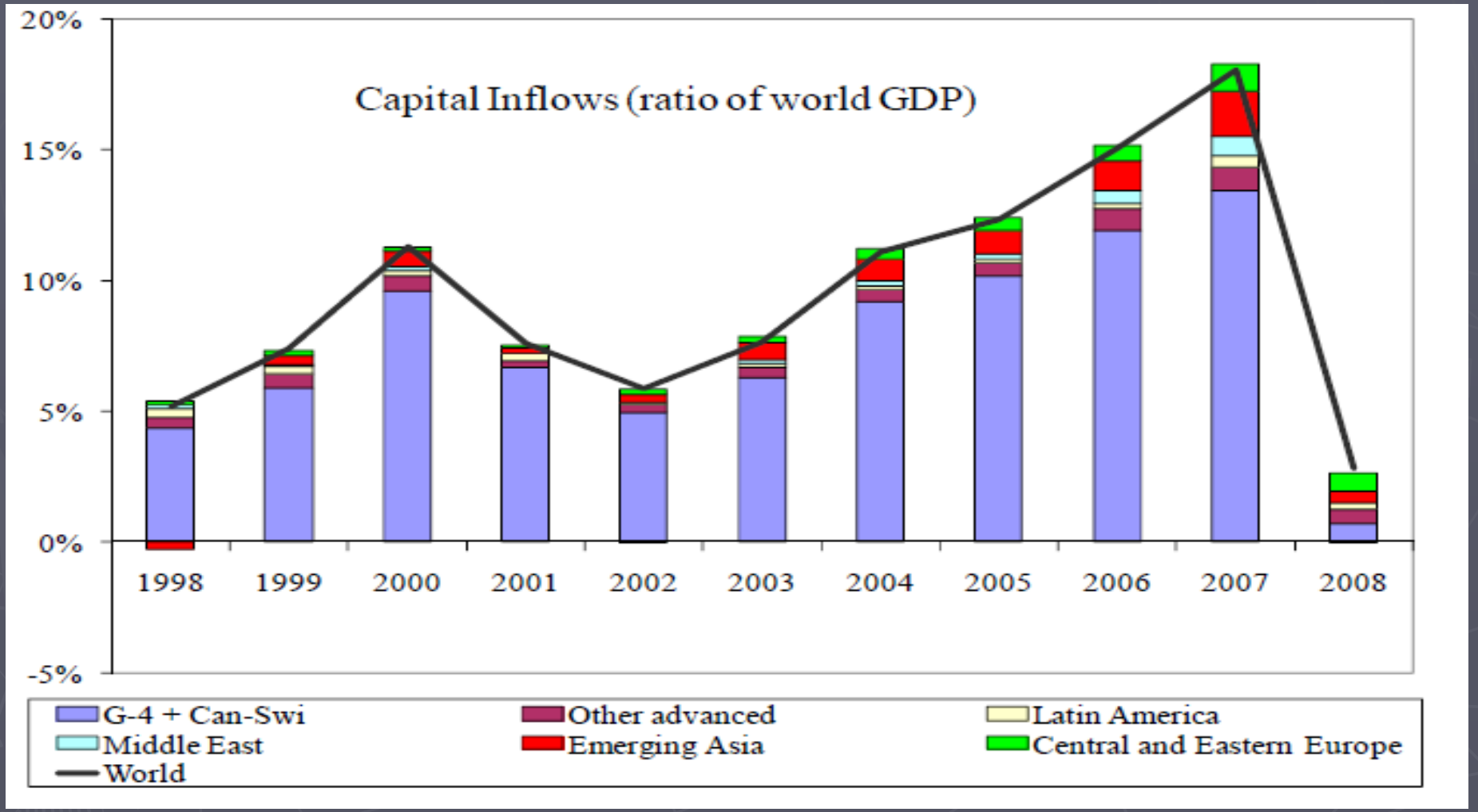
Note: Current account balances (in percent of world GDP). Source: World Economic Outlook (October 2009 forecast). The composition of country groups is as follows:

EUR surplus: Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Netherlands, Sweden, Switzerland.
EUR deficit: Greece, Ireland, Italy, Portugal, Spain, United Kingdom, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Turkey, Ukraine.
Emerging Asia: Hong Kong S.A.R. of China, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan province of China, Thailand.
Oil exporters: Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kazakhstan, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, United Arab Emirates, Venezuela, Yemen.
Rest of the world: remaining countries.

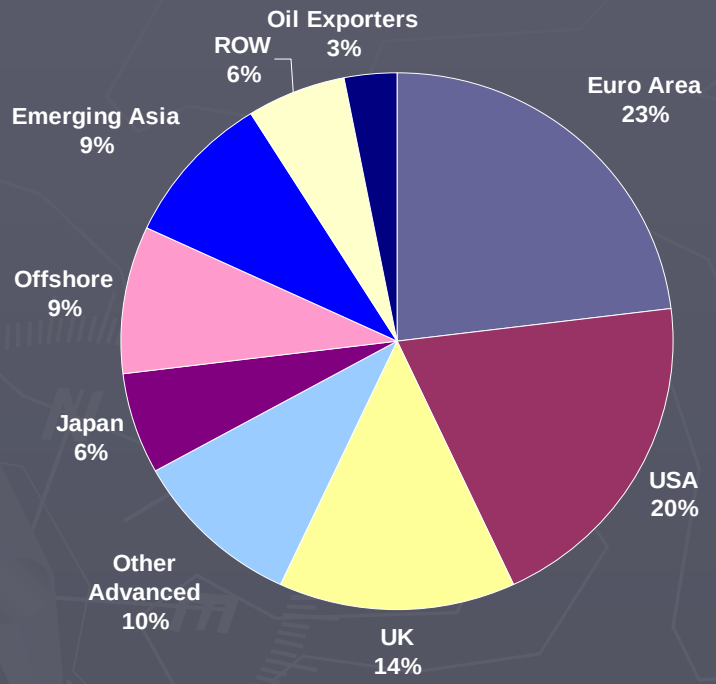
Global Capital Flows
1998 - 2008



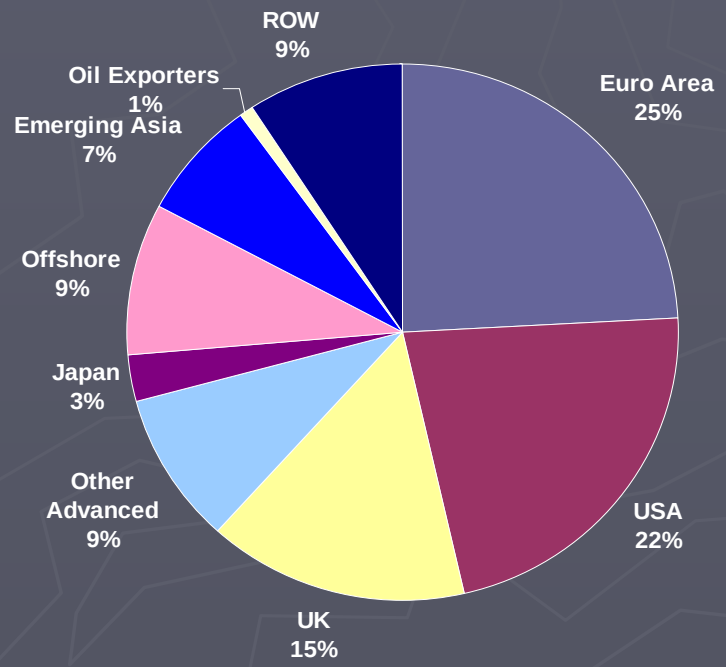
Capital Inflows
(ratio of world GDP)



As of end-2007, the euro area, US, & UK had the largest external portfolios

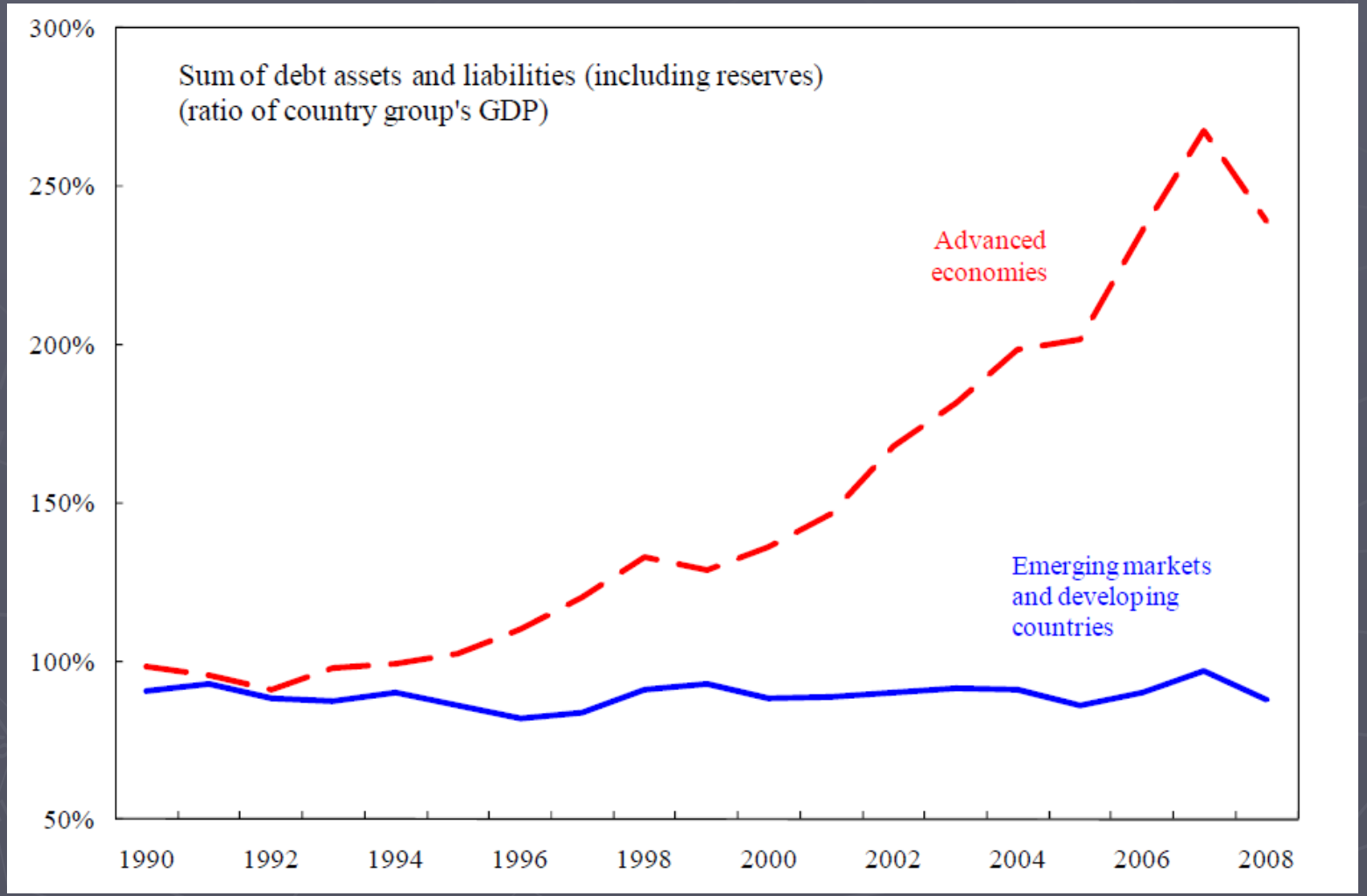


Total Assets (89 USD trill)

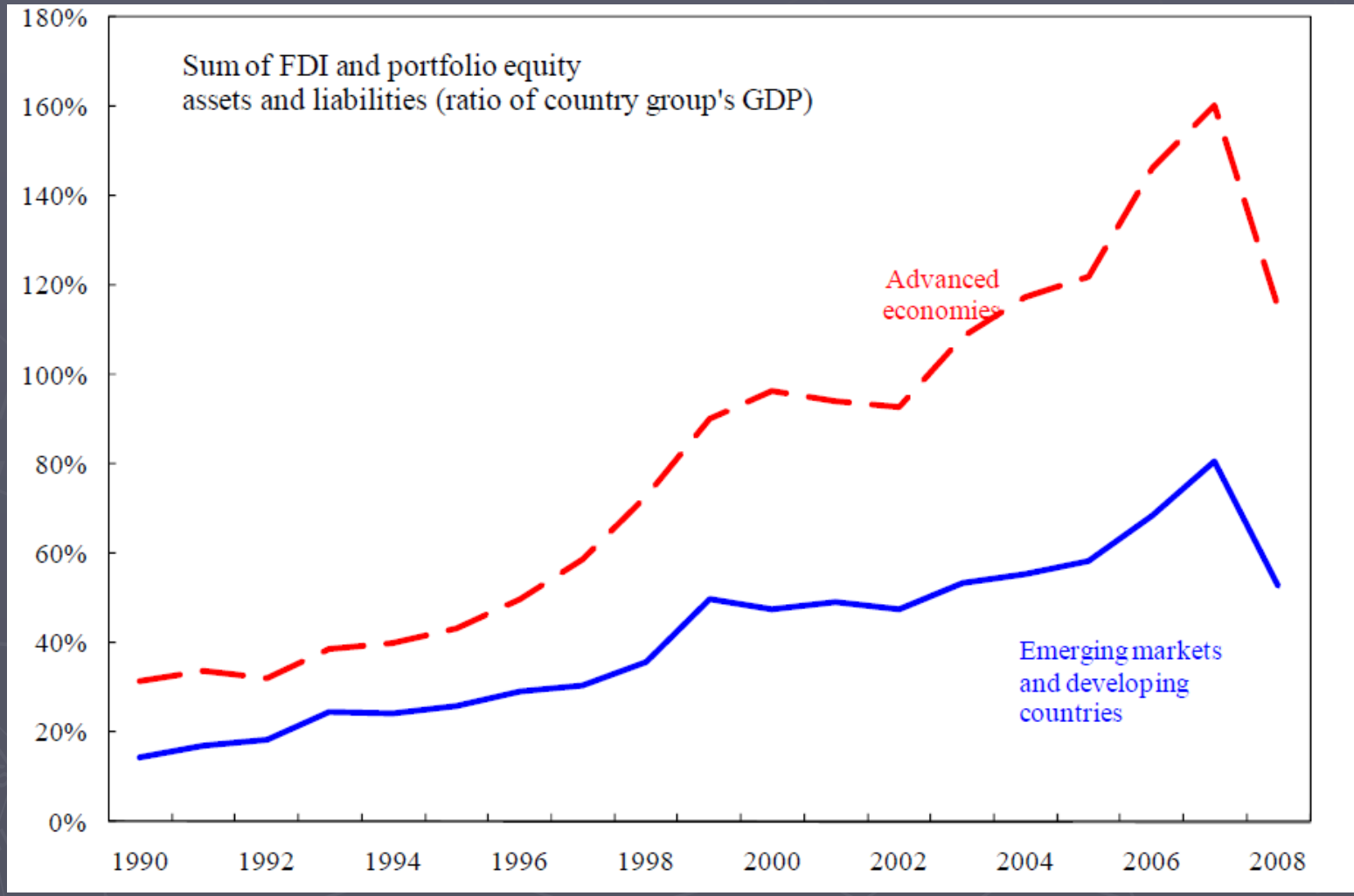


Total Liabilities (89 USD trill)

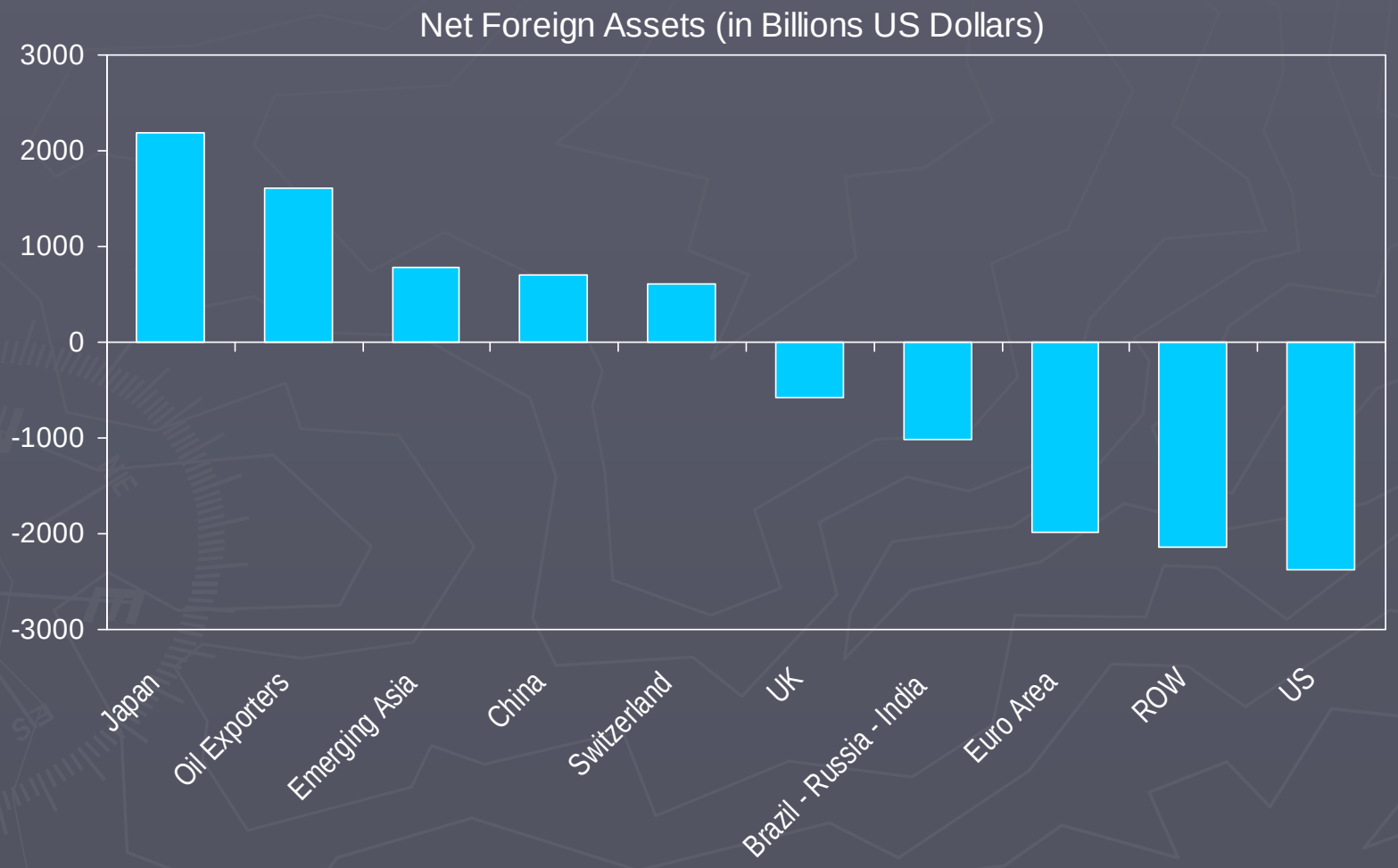
Composition of Cross-Border Holdings



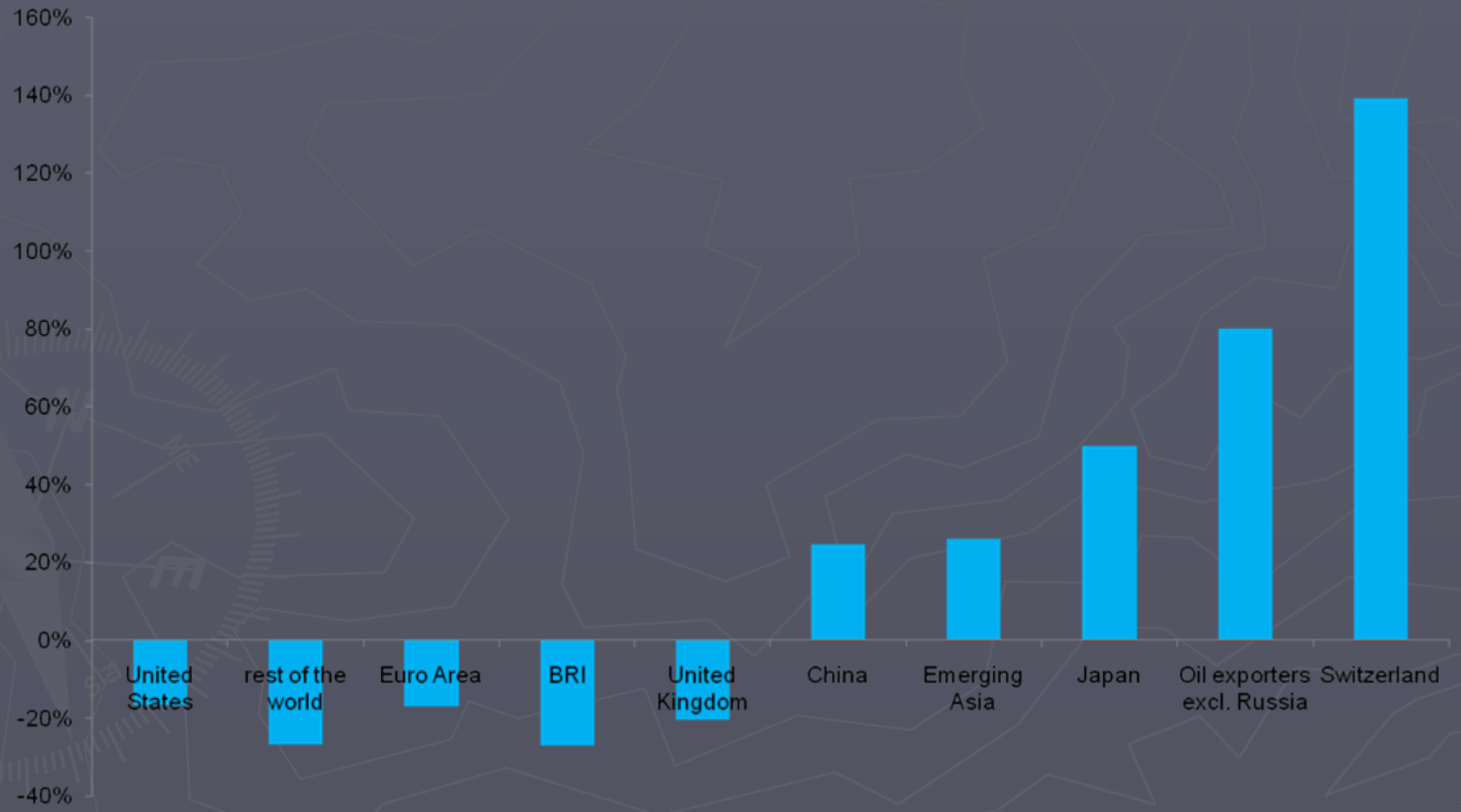
Composition of Cross-Border Holdings



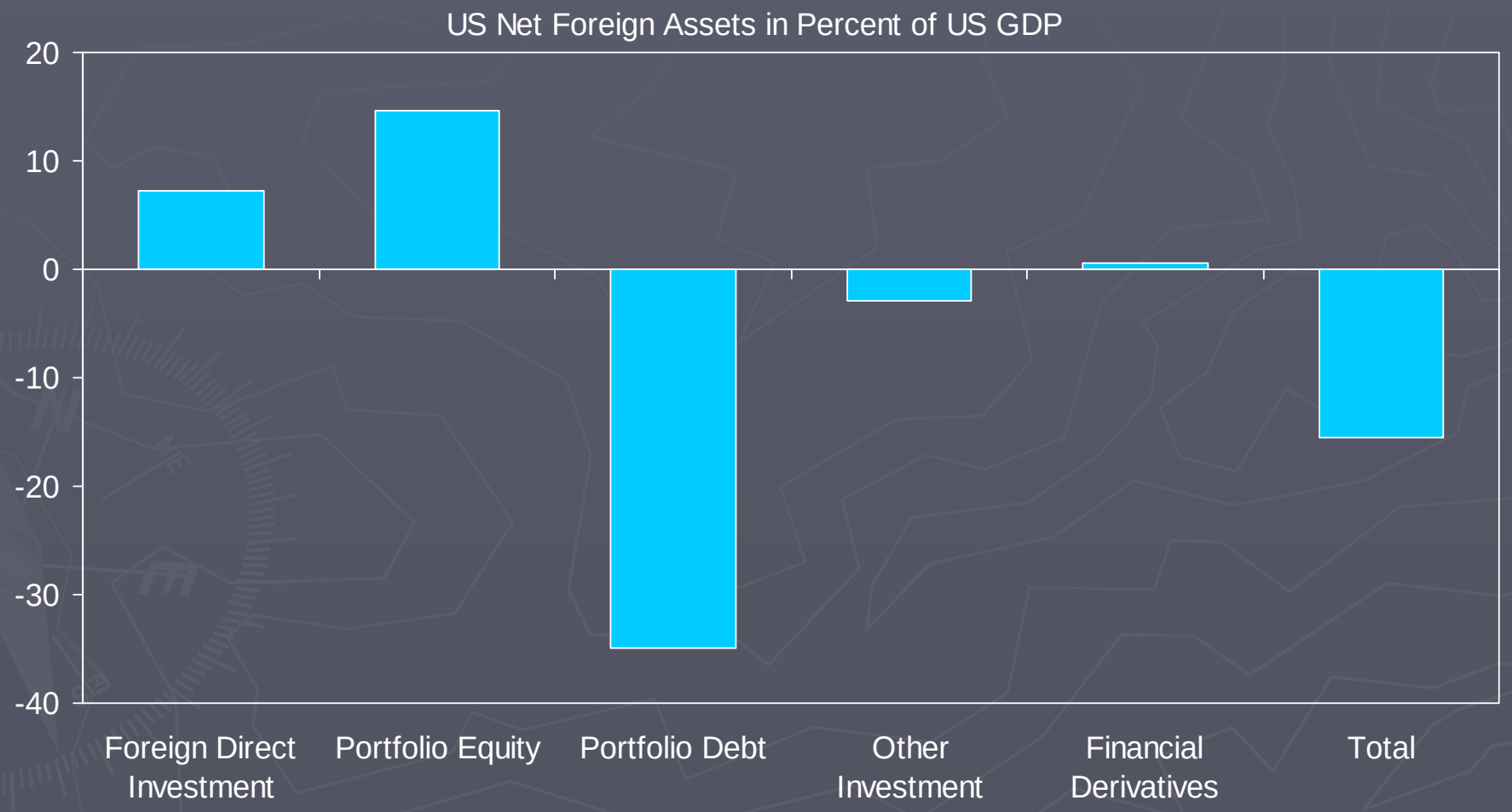
And of end-2007 the US, the Euro Area, Japan, Emerging Asia, and Oil Exporters held the largest net positions



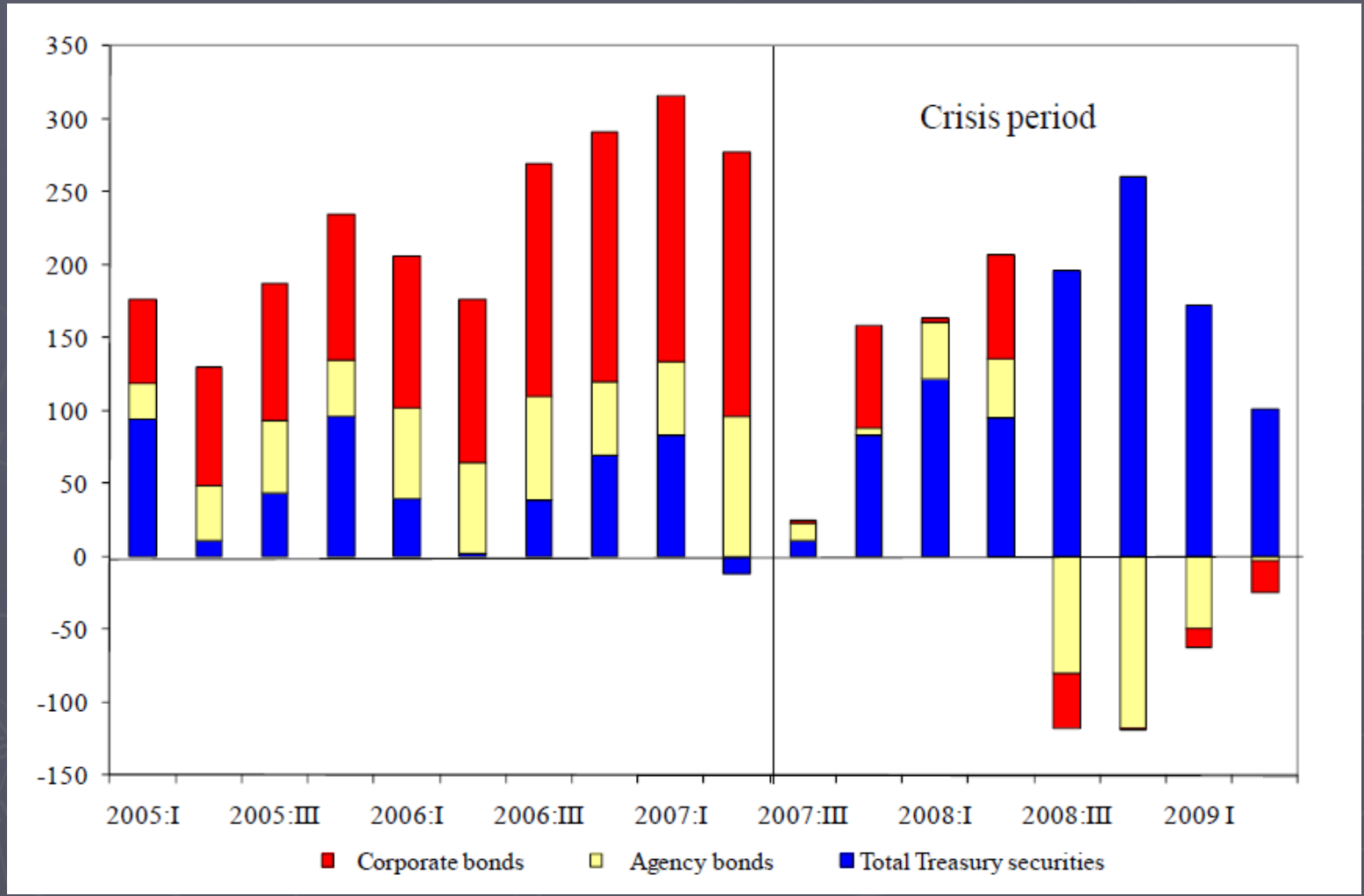
Net external position as a ratio of domestic GDP, 2007
(excluding gold holdings)



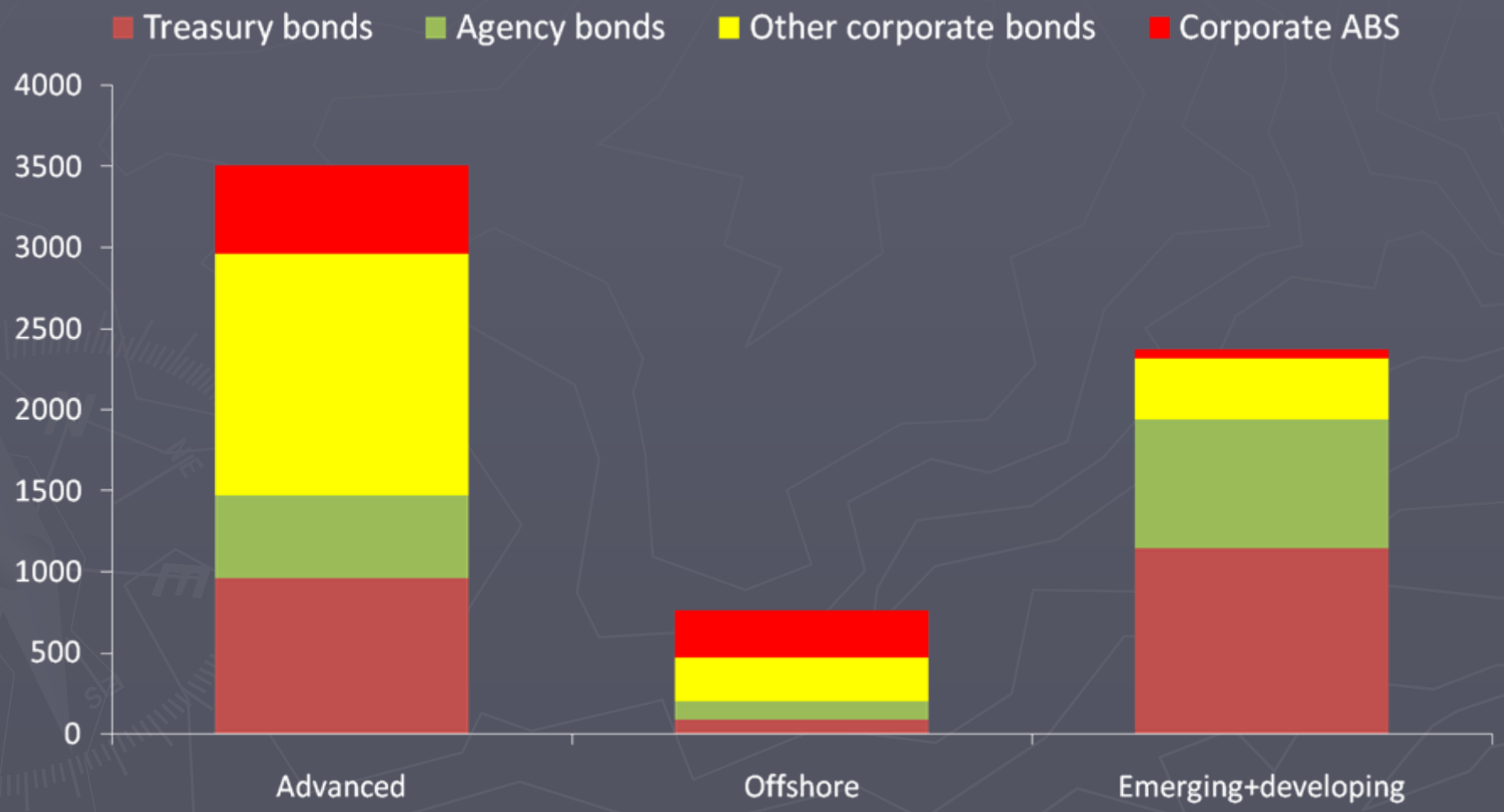
The US aggregate NFA position reflects large liabilities in debt instruments



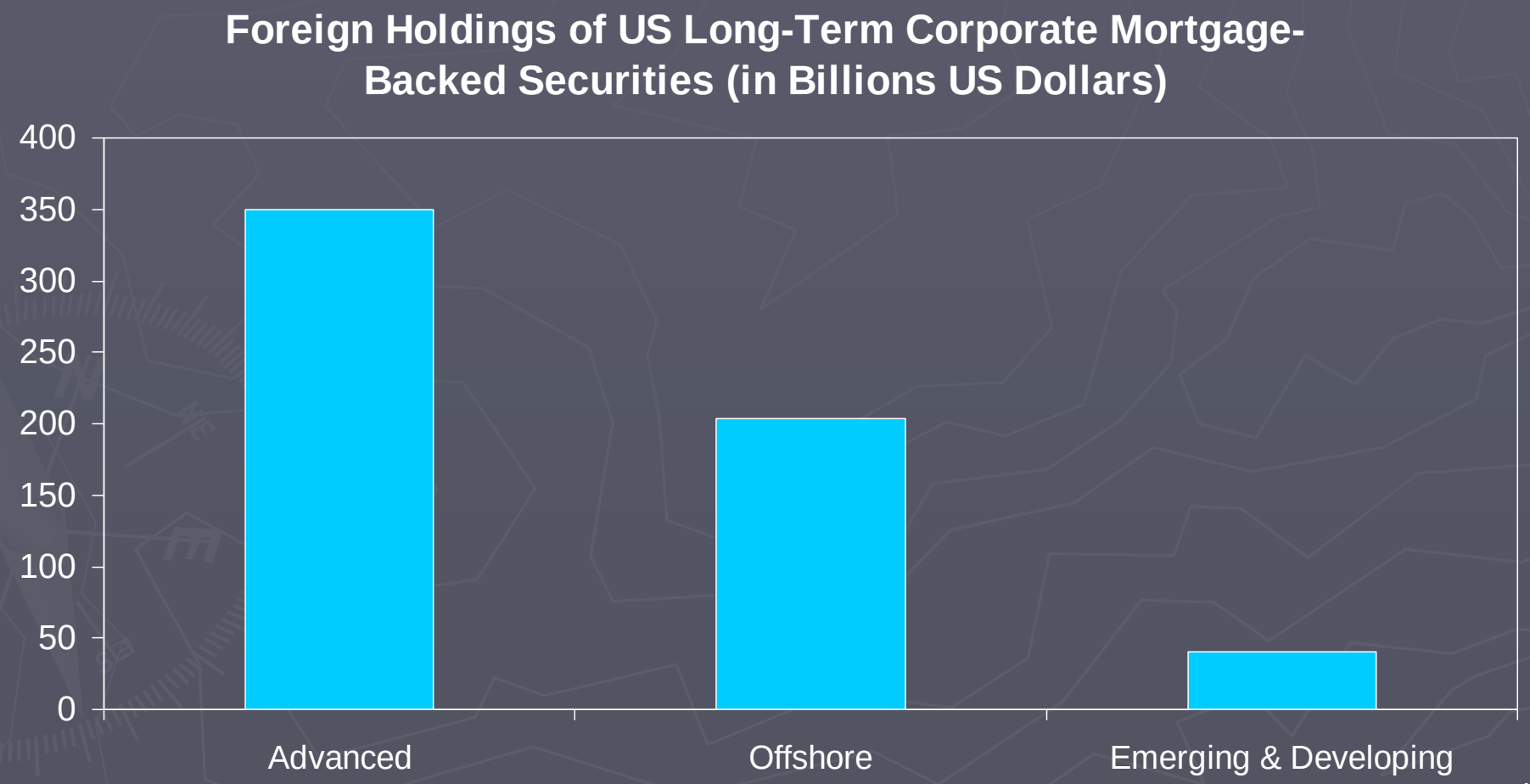
Foreign Purchases of U.S. Bonds
(billions of US$)



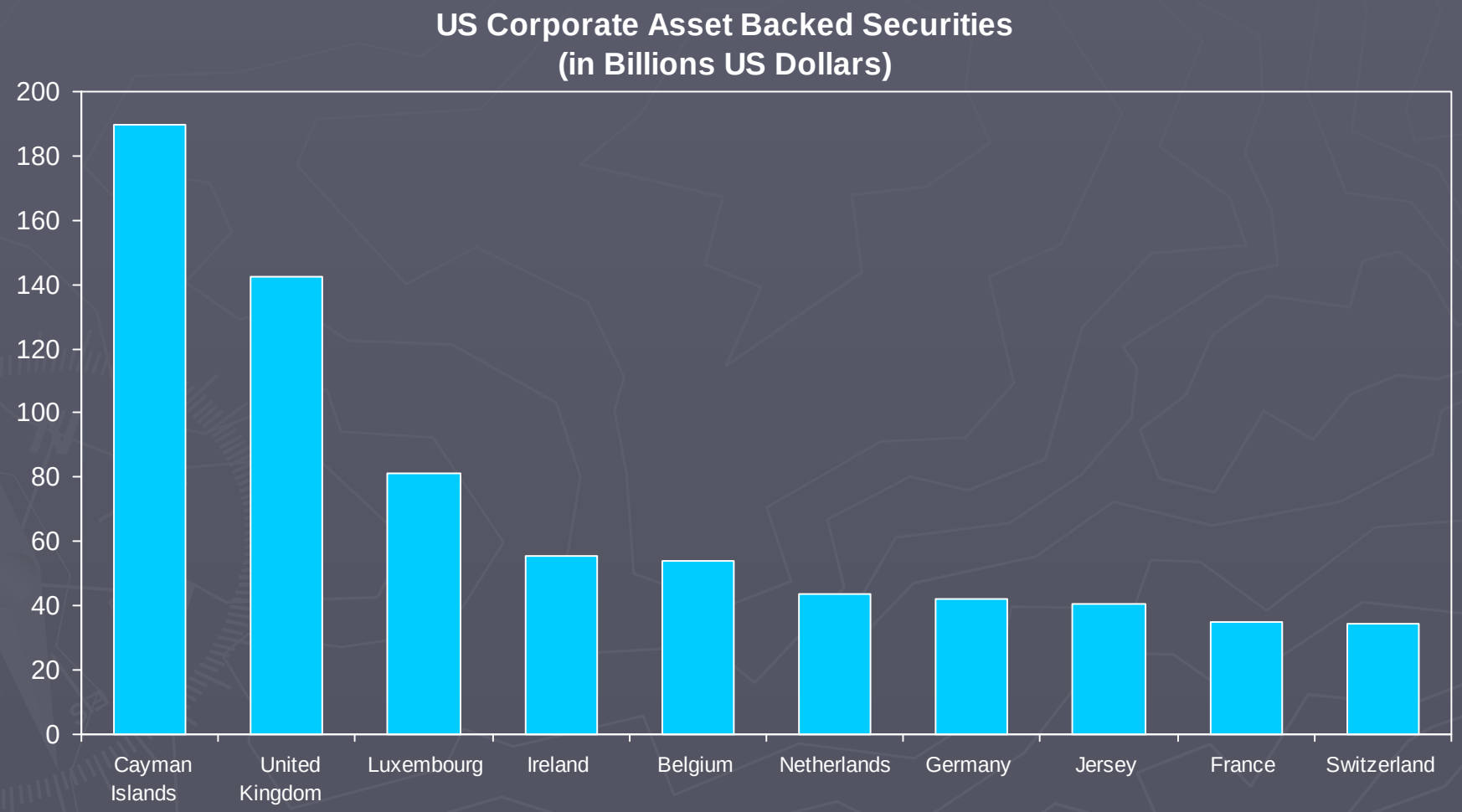
Foreign holdings of U.S. bonds by country and type (June 30, 2007)



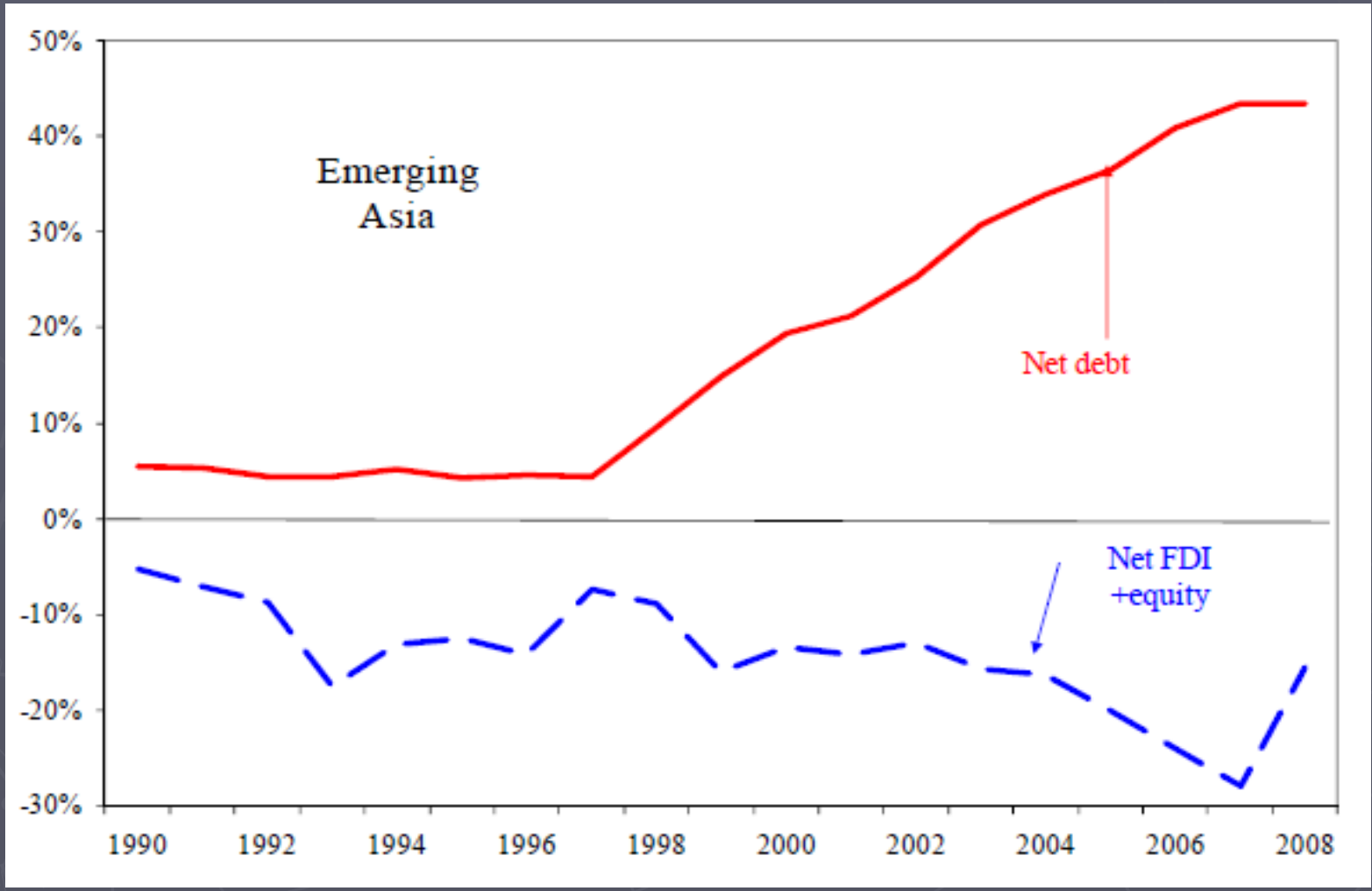
ABS securities represented a much larger portion of corporate bond holdings in advanced and offshore countries



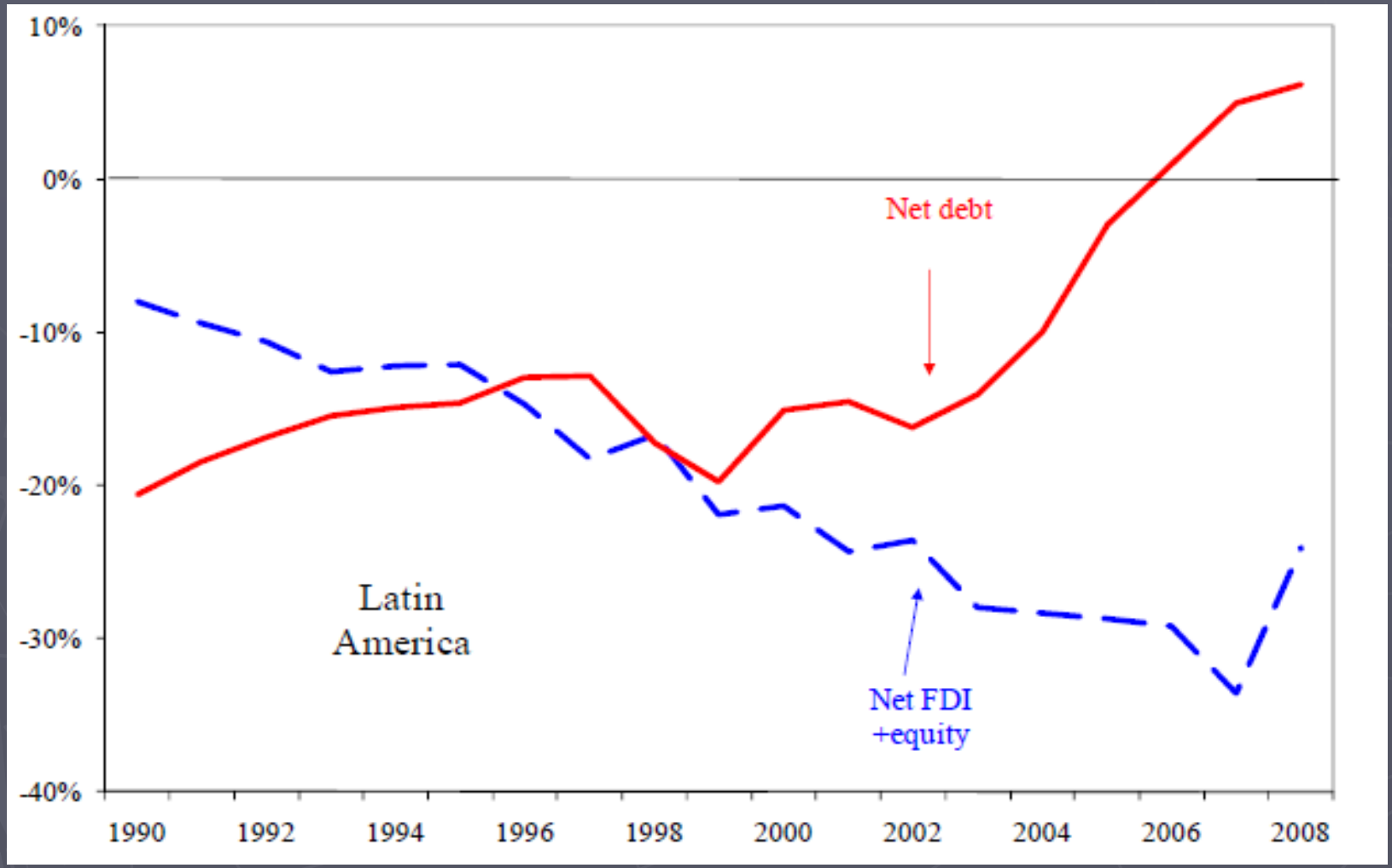
Largest Holders of US Private ABS : Europe and Financial Centers



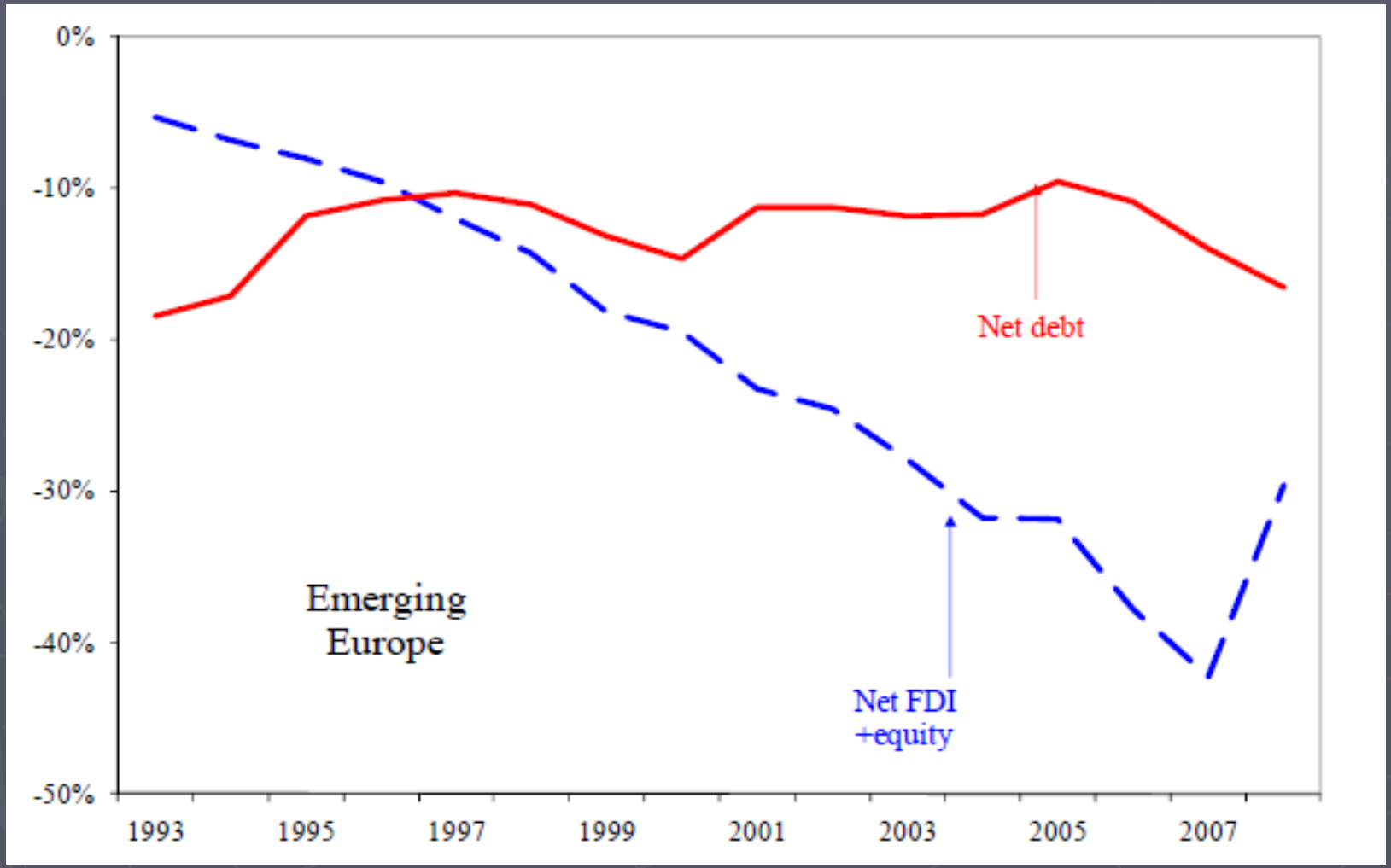
Emerging Markets: external portfolio structure



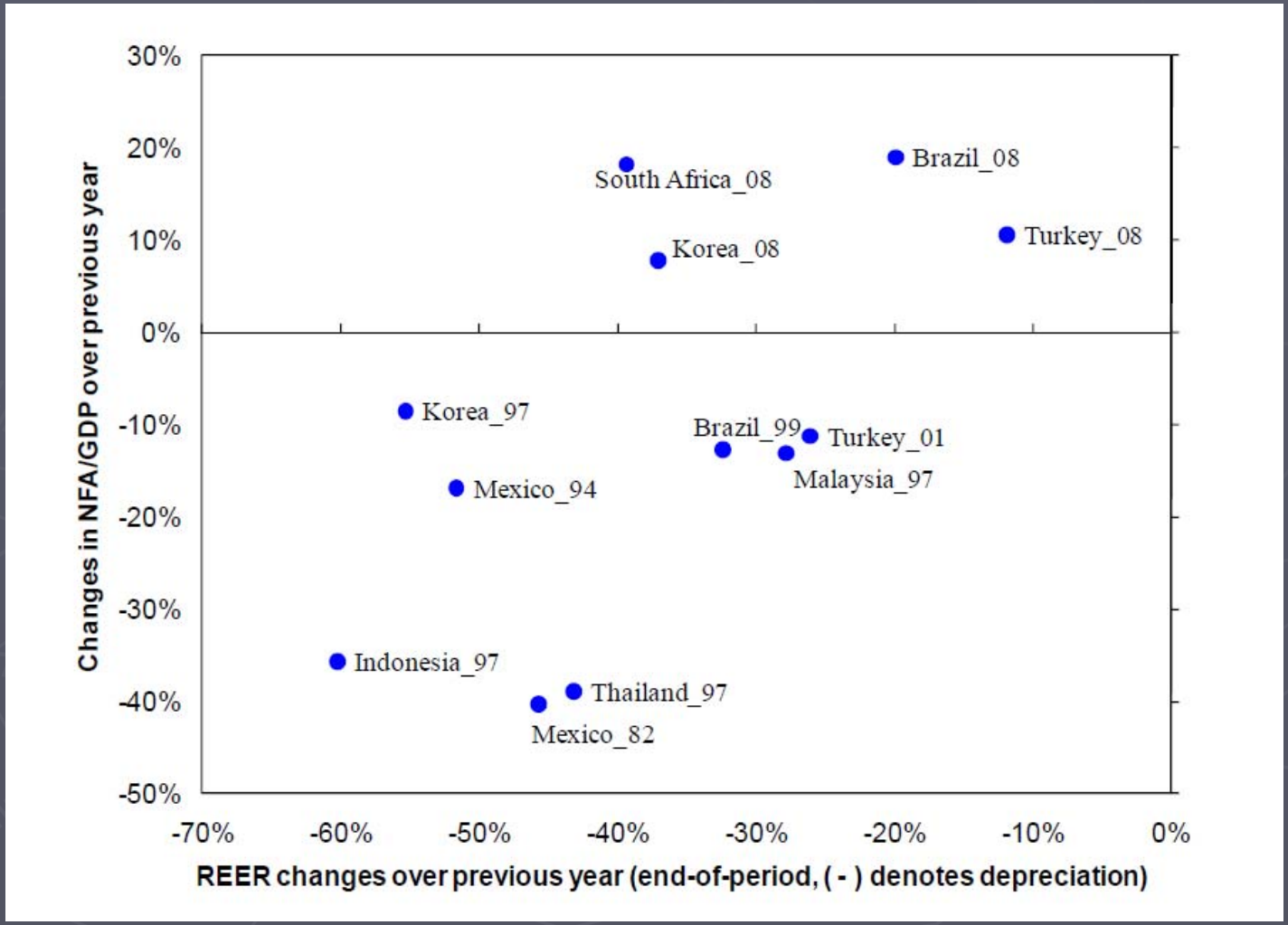
Emerging Markets: external portfolio structure



Emerging Markets: external portfolio structure



Emerging Markets: Real depreciation and change in external position: past and present



Global Output Levels
World Economic Outlook

	April 2007	October 2009	April 2007	October 2009	April 2007	October 2009
	World		Advanced Economies		Emerging and Developing Economies	
2006	100.0	100.0	100.0	100.0	100.0	100.0
2007	104.9	105.2	102.5	102.7	107.5	108.3
2008	110.0	108.3	105.2	103.3	115.1	114.8
2009	115.3	107.2	108.1	99.8	122.9	116.7
2010	120.9	110.5	111.1	101.1	131.2	122.7
2011	126.7	115.1	114.2	103.5	139.9	130.1
2012	132.8	120.2	117.3	106.2	149.1	138.4
2013	NA	125.7	NA	108.9	NA	147.5
2014	NA	131.4	NA	111.5	NA	157.3

Unemployment Rates

	Unemployed	2007	2008	2009	2010	2011	2012	2013	2014
Global (Adv. & G20 emerging)	In millions	93.42	95.72	117.92	122.27	114.46	108.21	104.27	101.65
	In percent	5.47	5.52	6.68	6.83	6.31	5.88	5.59	5.37
Advanced	In millions	27.07	29.35	41.64	47.46	43.92	38.31	34.41	32.25
	In percent	5.40	5.80	8.20	9.29	8.56	7.43	6.64	6.19
G20	In millions	87.51	89.24	108.22	111.26	103.87	98.21	94.90	92.82
	In percent	5.45	5.47	6.51	6.59	6.08	5.66	5.39	5.19
G20 (non-adv.)	In millions	66.35	66.37	76.29	74.81	70.54	69.91	69.86	69.39
	In percent	5.87	5.51	5.40	6.07	5.84	5.43	5.28	5.18

Debt and Primary Balances
(in percent of GDP)

	Current WEO Projections 2010			Illustrative Fiscal Adjustment Strategy to Achieve Debt Target in 2030	
	Gross Debt	Primary Balance	Structural PB [1/]	Structural PB in 2020-30 [2/]	Required adjustment between 2010 and 2020
Belgium	102.7	-2.3	-0.4	5.3	5.6
France	85.4	-6.2	-2.1	4.0	6.1
Germany	84.5	-2.3	-0.4	3.0	3.4
Greece	115.0	-2.0	-2.2	6.8	9.0
Ireland	75.7	-11.1	-8.2	3.6	11.8
Italy	120.1	-0.7	1.0	5.8	4.8
Spain	69.6	-11.0	-5.8	4.9	10.7
United Kingdom	81.7	-10.9	-7.8	5.0	12.8
United States	93.6	-8.1	-3.7	5.1	8.8

Source: IMF, SPN/09/25, table 7.

[1/] Excludes losses from financial system support measures in the United States. Structural balances are reported in percent of nominal GDP.

[2/] Primary balance is assumed to improve gradually during 2011-20; thereafter, it is maintained constant until 2030. The last column shows the primary balance improvement needed to bring debt ratio to 60 percent in 2030 The analysis makes simplifying assumptions: in particular, beyond 2011, an interest rate-growth rate differential of 1 percent is assumed, regardless of country-specific circumstances.