The Federal Reserve Board

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At the Center for Strategic and International Studies, Washington, D.C.
December 18, 2001

Financial Stability in Emerging Markets: What Have We Accomplished and What Remains To Be Done?

Economic crises in emerging-market economies were a prominent feature of the economic landscape during the second half of the 1990s. Though such crises were by no means a new phenomenon, what brought special attention to the recent episodes was the perception of a heightened possibility of contagion--the spread outward of pressures from one crisis country to other countries. The risk of such contagion became evident when the collapse of Thailand's currency triggered a cascade of crises in other Asian emerging markets. Pressures could also spread through world financial markets to industrial economies, as happened with the Russian financial crisis.

In the wake of the Asian crises in particular, initiatives were launched on several fronts to improve financial stability in emerging-market economies and thus to reduce the frequency and intensity of future crises. These initiatives have ranged widely, from efforts to improve policymaking in emerging-market economies in areas such as choice of exchange rate regime and debt management to development of international standards and codes of best practices and to reforms of international financial institutions. Today, I venture an assessment of how much progress has been made and how much remains to be done. I believe that there have been improvements in our understanding of the causes of crises, in economic policymaking in emerging-market economies, and in international institutional arrangements. The key to preventing future financial crises is for emerging-market economies themselves to institute sound domestic economic policies and to build robust domestic financial institutions. No improvements in international financial architecture can make up for deficiencies in these crucial areas.

Reducing Contagion and Promoting Financial Stability

Before I evaluate prescriptions for reducing the likelihood of emerging-market financial crises, I need to examine the causes of such crises. In general, financial crises result from adverse shocks to an already vulnerable economy. External shocks that a robust economy would shrug off can have a disproportionate impact on an economy beset by speculative excesses in asset markets, poor risk management, and inadequate regulation and supervision of the banking system.

In broad terms, this describes the Asian emerging-market economies in the run-up to their crises in the late 1990s. Countries in the region did experience external shocks, including a slump in the semiconductor market and an appreciation of the dollar relative to the yen, that undermined their competitiveness. However, these shocks alone were not sufficient to account for the dimensions of the ensuing crises. The problem was that the shocks hit economies suffering from speculative excesses in their financial and real estate markets.

Serious deficiencies in corporate governance and prudential oversight resulted in inadequate restraint on firms' indulgence in risk. Financial sectors were weakened by political interference in lending decisions and the moral hazard associated with wide-ranging, albeit often implicit, government credit guarantees. As a result, banks had insufficient incentives to manage their credit risks, and firms had inadequate incentives to limit their leverage and make sound investments. In particular, the corporate sector was enormously leveraged, and longer-term domestic investment projects were financed with shorter-term foreign-currency-denominated borrowing. Pegged exchange rate regimes in the presence of volatile international capital flows created additional vulnerabilities. Financial sector weaknesses, rigid exchange rate regimes, and volatile capital flows combined to yield a highly combustible mixture that, with the spark of adverse external shocks, ignited currency and debt crises, including the collapse of banking systems throughout the region

The Asian crisis experience highlights the crucial importance of robust institutions and sound policies in mitigating the risks emanating from external financial shocks. One implication of this view is the importance of policy "sequencing" in emerging-market economies. Sequencing involves constraining the pace of increased participation in global financial markets to the pace at which a sound domestic economic infrastructure can be put in place. In particular, capital account liberalization in emerging-market economies needs to be preceded by significant progress in strengthening domestic financial systems. If liberalization proceeds too rapidly, the economy becomes vulnerable to risks associated with volatile capital flows. In the years leading to the Asian financial crises, the region moved toward capital account liberalization while domestic financial institutions and regulations were still underdeveloped. This mismatch encouraged excessive foreign borrowing, especially at short-term maturities, that greatly exacerbated the impact of the crises.

Of course, some policymakers could use sequencing as a pretext to put off capital account liberalization indefinitely. With this concern in mind, some have argued that we really need to encourage rapid liberalization, independent of the state of financial sector institutions, in the hope that financial liberalization would pressure the authorities to improve supervision and regulation more quickly. I believe that the Asian crisis provides a strong argument against this approach. Before proceeding with capital account liberalization, a country needs to carefully consider deficiencies in domestic financial institutions, corporate governance, and bank regulation and supervision. Emerging-market economies in which such financial market infrastructure is still in an early stage of development should consider the use of prudential regulations that discourage capital inflows, especially short-term capital flows, along the lines of the approach formerly in place in Chile. Such regulation of capital flows may be appropriate in the period before robust domestic institutions and sound policies are fully in place and tested by experience.

The Process

The Asian financial crises generated several initiatives aimed at preventing or better managing future crises. The academic and policy communities have sought a better understanding of the causes and transmission mechanisms of crises. There have also been initiatives to reform what has come to be called the international financial architecture. Issues related to the prevention and management of emerging market financial crises have entered the agenda--and sometimes dominated the discussions--of the G-7 in recent years. In addition, some groups have been formed specifically to study such issues. The G-20, which includes finance ministers and central bank governors from major emerging-market countries in addition to the G-7, was launched in September 1999 to facilitate dialogue between systemically important countries and to promote international stability. The G-20 has recently focused on reform of the international financial architecture and the implications of globalization.

I have participated in two of the new groups established in response to the Asian financial crisis: the Manila Framework Group and the Financial Stability Forum. I represented the Federal Reserve at the first Manila Framework meeting and in the Financial Stability Forum for the last few years. My focus in these groups has reflected my specialties at the Board, including Asia-Pacific developments and bank supervision and regulation.

The Manila Framework Group was founded in November 1997, in the throes of the Asian crisis, with the aim of restoring financial stability in the region. It consists of finance ministry and central bank officials from fourteen Pacific countries, including the United States. The group has met twice a year and has undertaken a number of studies and launched cooperative ventures among its members.

The Financial Stability Forum was established by the G-7 in April 1999, after the Asian and Russian financial crises, to provide a means for cooperation in the supervision of financial markets among national governments, international financial authorities, regulatory groups, and other experts. The forum's membership includes central bank and treasury representatives and a financial services supervisor from each of the G-7 countries; a single representative of a few more economies; and representatives of several international financial institutions and of global standard setters for banking, securities, and insurance. The forum is supported by working groups, committees, and task forces, which often include the participation of several emerging-market countries. The forum's mandate is to identify vulnerabilities affecting the international financial system and to improve coordination and information exchange among the various authorities responsible for financial stability. Its working parties have addressed issues such as off-shore financial centers, highly leveraged institutions, and short-term capital flows.

The international official community has also taken up initiatives to reform the international financial institutions, inspired in part by proposals put forth in 1999 by Lawrence Summers, then Treasury Secretary. As a result of this process, the International Monetary Fund (IMF) and the multilateral development banks have instituted many changes, which I will discuss in more detail later, and reform initiatives continue.

What We Have Accomplished

Recent work, both under the auspices of the groups I just enumerated as well as elsewhere, has resulted in substantial achievements. We have a better understanding of the policies and institutional frameworks best suited to creating financial market stability in emerging-market economies, and changes in the international institutional environment have facilitated the adoption of such policies. I want to discuss five of the most important changes--choice of exchange rate regime, debt management policies, promulgation of standards and codes, reform of the international financial institutions, and private-sector involvement in debt restructurings.

Exchange Rate Regimes

The financial crises that enveloped Mexico, Russia, and several Asian developing countries in the 1990s reinforced what already appeared to be a growing consensus against pegged exchange rates. The experiences of these countries showed that pegged exchange rate regimes greatly limited the ability of real exchange rates to adjust in reaction to external shocks and restricted monetary authorities' ability to correct excessive growth of credit or to act as lender of last resort. Fixed rates also tended to encourage excessive borrowing of foreign currency, by reducing concerns about exchange rate risk, and contributed to particularly abrupt and disruptive reversals of investor confidence once exchange rate pegs were broken.

Some countries, particularly those in which monetary policy has had low credibility, have felt that the adoption of a fixed exchange rate was necessary to reduce inflationary expectations. In particular, countries with histories of high inflation and poor macroeconomic management may have felt the need for fixed exchange rates, at least for a transitional period, until they developed a better track record for policy performance. In such cases, a key question is how long the rigid exchange rate regimes must stay in place before inflationary expectations can be reduced.

The experience of the 1990s suggests that, in the context of rapid international capital mobility, sustaining a fixed exchange rate in the face of domestic policy imbalances or international financial market shocks is very difficult, and a forced abandonment of a pegged rate under pressure has proved quite disruptive. To provide greater stability to fixed-rate regimes, some countries have adopted currency board systems or moved to full-blown dollarization. However, such moves are by no means panaceas, as evidenced by Argentina's current difficulties. Considerably more countries have moved in the opposite direction--toward more freely floating exchange rates--often following experiences in which their pegged exchange rates proved not to be viable.

I believe that, as a general rule, flexible exchange rate regimes are the best choice for emerging-market economies. A fixed-rate regime is appropriate only in the relatively rare instances in which it can be fully credible. The fact that many policymakers in emerging-market economies seem to have adopted a similar viewpoint in recent years provides some grounds for optimism that, in the future, emerging-market economies may experience fewer and less severe financial crises.

Debt Management

In recent years, a broad consensus has emerged within the international official community that prudent debt and liquidity management is a key element of crisis prevention. Emerging-market economies that experienced financial crises in the late 1990s generally had significant mismatches in the composition and maturity of their liabilities and assets that left them vulnerable to external shocks. In particular, almost all the crisis countries had high ratios of short-term external debt to foreign reserves. There was too much emphasis on borrowing strategies that aimed simply at minimizing short-term funding costs and that, in the process, created significant rollover risks. Authorities also failed to adequately monitor national balance sheets on a consolidated basis, while taking into account off-balance-sheet obligations, implicit government guarantees, and various other contingent liabilities that might arise if the private sector were unable to honor its obligations.

One general principle to draw from this experience is that emerging-market countries should avoid issuing large quantities of short-term debt because ongoing exposure to rollover risk intensifies vulnerability to changes in market conditions. Some initial fiscal cost may be associated with lengthening debt maturities because long-term interest rates generally are higher than short-term rates. However, to the extent that lengthening the maturity of a country's debt improves its fiscal viability and reduces the likelihood of having to borrow at the high rates charged during a crisis, any increase in debt-service costs should be seen as a prudent insurance premium. In addition, the development of domestic government securities markets, in which debt denominated in local currency can be issued, can help reduce the vulnerability to shifts in global capital flows.

The international financial institutions have launched several initiatives to help emerging-market countries improve their debt- and risk-management policies. Last year, the IMF and World Bank staffs, responding to discussions initiated by the Financial Stability Forum, completed a document entitled "Guidelines for Public Debt Management" that was based on some of the principles just discussed. These guidelines will be used to inform the IMF's technical assistance and surveillance efforts. The IMF is also conducting research examining various indicators that may serve as guideposts for debt and may help in managing reserves in emerging-market economies.

Standards and Codes

Among the initiatives that arose from the emerging-market crises was the international official community's effort to articulate "standards and codes" to encourage improved practices in the economic and financial policies of emerging-market countries. Some noteworthy progress has been made in this area. Standards and codes have been developed that cover a wide array of areas, including data quality and dissemination, transparency in monetary and fiscal policy, and best practices in banking supervision, payment systems, and accounting standards. The Financial Stability Forum has focused on ways to provide incentives for greater compliance with the standards and codes. The IMF is leading the implementation of this effort, but other international bodies--including the World Bank, the Basel Committee, and the Organization of Economic Cooperation and Development--are also taking part. Examples of actions so far include the Financial Sector Assessment Program, under which IMF and Bank staff assess the strengths and vulnerabilities of member countries' financial sectors, and the IMF preparation of reports on the observance of standards and codes, which address a country's progress on meeting standards in a broad range of areas.

While promising, these initiatives have not been without difficulties. Implementation and compliance in the emerging-markets countries is uneven, and much remains to be done. Market participants are beginning to pay more attention to compliance with standards and codes, but scope for significant progress in this area remains. For example, compliance does not appear to be important in setting credit ratings or lending terms. More fundamentally, some emerging-market countries have complained of a lack of sensitivity to their particular circumstance, and have called for a more realistic view of the feasible pace of reform and clearer priorities. For emerging-market economies, it makes sense for standards and codes to focus on minimum standards because the appropriate standards will vary across countries depending on the resources and experience of officials, the structures of financial systems, and the cultural values and norms. Because a country may have unique circumstances, not all international standards are appropriate for each emerging-market economy. In the Basel II process, for example, standards appropriate for large, internationally active banks in the developed industrial economies may be inappropriate for emerging-market economies.

Reform of International Financial Institutions

Another focus of reform efforts in recent years has been the international financial institutions. Changes have been made, and more are planned. The IMF's lending facilities have been modified, including the introduction of an "expectation of early repurchase," which will tend to reduce the maturity of IMF lending, and an escalation of loan charges once a country's outstanding obligations to the IMF exceed certain thresholds. These measures are intended to encourage countries' return to capital markets as quickly as possible and to discourage excessive dependence on IMF financing.

The IMF also has recently moved to make the pricing of its Contingent Credit Lines, or CCL, more attractive to potential borrowers. The CCL was established in 1999 to provide liquidity to prequalified countries with track records of sound policies. However, this facility has never been used. Countries have expressed concerns that the benefits of being prequalified are more than offset by the potential costs of being disqualified if their policies subsequently are deemed to have weakened. Countries have also voiced concerns that simply applying for the CCL may be interpreted by the markets as a signal of vulnerability.

As mentioned previously, the IMF has also moved to improve its ability to assess the economic and financial vulnerabilities of its members, including efforts to identify national balance sheet and liquidity risks, as part of a broader initiative to strengthen the IMF's surveillance efforts. Measures to discourage misreporting have been strengthened, and efforts have been made to make the IMF's operations more transparent, including the publication of policy documents.

The role of conditionality in IMF programs has been a subject of ongoing debate. Critics have argued that these programs, particularly those constructed during the Asian crises, have carried too many detailed conditions and have focused disproportionately on structural objectives rather than on the macroeconomic issues that are the IMF's core mandate. It has been argued that this represents micromanagement and reduces the scope for country ownership of adjustment programs. In response to this critique, the IMF has said that it is moving to streamline and focus conditionality, particularly with respect to structural measures, and to provide greater clarity as to why conditions in certain areas are included in or excluded from programs. Though efforts to provide greater focus to conditionality are welcome, they should not come at the expense of the underlying rigor of Fund programs or the protection of its resources that conditionality provides.

There have also been initiatives to reform the multilateral development banks. It has been suggested that there should be increasing selectivity in projects, a reform in pricing policies involving more differentiation across lending activities and borrowers, and improved methods of monitoring the compliance of borrowers. In addition, there have been calls for the IMF and the World Bank to show greater sensitivity to the needs of the world's poorest countries. The process of translating these general principles into concrete policies has somewhat progressed, but it appears still to be in its early stages.

Private-Sector Involvement

An important and evolving aspect of dealing with emerging-market financial crises is what has come to be referred to as private-sector involvement. The central issue here is the role of private-sector creditors during default or restructuring of an emerging-market economy's debt. Unlike the bankruptcy of a firm in a domestic market, for which procedures are generally codified and settled, the default of a sovereign nation currently involves no binding legal jurisdiction or enforcement mechanism. The goal of private-sector involvement is to ensure that, in a crisis, private-sector creditors, particularly bondholders with instruments denominated in or linked to a foreign currency, participate in efforts to resolve the problem. Such participation can take various forms--debt exchanges, rollovers, restructurings, provision of new money, or outright losses.

The extent to which the private sector has helped resolve emerging-market crises has evolved over time. During the debt crises of the 1980s, official support generally was focused on financing current account shortfalls and easing the macroeconomic adjustment process. Bank creditors restructured old loans, extended new loans, and eventually--under the Brady plan--exchanged their loans for bonds with diminished value. During the 1990s, however, bonds became much more important as sources of credit for many countries. This greater importance raised new issues for debt restructuring, given the more atomistic and dispersed nature of bondholders as a group. The emergence of very large international support packages--for Mexico in 1995, several Asian countries and Brazil in 1997 and 1998, and Turkey and Argentina more recently--may be seen in part as a response to the perceived difficulties of engaging private creditors, particularly bondholders, in the resolution of emerging-market debt problems. This point, however, should not be overstated. Many private investors--most notably those who invested in equities--have taken substantial losses during recent crises.

The provision of large financial-assistance packages has been criticized because of a focus on only two possible outcomes for emerging-market economies facing financial difficulties--either default or no default, with the international official community viewed as often endeavoring to avoid default at all costs. Developing procedures aimed at facilitating intermediate solutions--namely, some form of debt restructuring with private-sector involvement--might, in this view, help avoid disruptive, corner solution outcomes. Moreover, large support programs have been criticized for exacerbating so-called moral hazard by encouraging overborrowing and overlending through leading investors to believe that the official community will bail them out should debt repayment problems arise.

A key argument for private-sector involvement is that markets will price risk properly and allocate resources efficiently only if investors are forced to bear the costs of their bad decisions. The hope is that, if the broad principles for achieving private-sector involvement are known in advance, they might reduce investors' uncertainty about the rules of the game and help to ensure that workouts proceed smoothly and predictably. The principles could facilitate orderly resolution of financial crises and might also help prevent crises by reducing uncertainty as to how investors would be dealt with during times of crisis.

In recent years, a tremendous amount of discussion has been devoted to considering means by which private investors could be involved during financial crises on an orderly, systematic, and predictable basis. Yet these efforts still have a long way to go. Some members of the official community find it difficult to accept the notion of sanctioning arrears or default. Also, some have concerns that strict limitations on official IMF support could constrain the official sector when such support was genuinely needed to avert international contagion.

Agreement on abstract principles of private-sector involvement remain elusive, but on the practical level, instances of private-sector involvement are accumulating, laying down a foundation of practices and precedents that should serve to make future restructurings more orderly and predictable. In recent years, international bond restructurings have been conducted by Pakistan, Ukraine, and Ecuador as a means of either dealing with an existing default or avoiding an impending default. In addition, the IMF-led financial assistance to both Turkey and Argentina has included various forms of private-sector involvement. The authorities in Argentina are currently exchanging government debt on terms that involve significant concessions from the private sector.

IMF First Deputy Managing Director Anne Krueger has recently weighed in on the issue of international bankruptcy arrangements. She proposed that, in the event of an imminent financial crisis by an IMF borrower, there should be, among other policies, an IMF-sanctioned temporary standstill on debt-service payments and negotiated restructurings under IMF auspices of debts to private-sector creditors. Though better international bankruptcy arrangements have certainly been a longstanding need--as noted by Chairman Greenspan as far back as 1995, immediately after the Mexican crisis--an initial reading of Krueger's proposal suggests that it would face very significant practical problems. The major problem with the Krueger proposal, as with any scheme to establish international bankruptcy arrangements, stems from the fundamental fact of the political sovereignty of nations. Debtor and creditor countries alike would have to cede significant sovereignty to the IMF under Krueger's proposal and would almost certainly prove reluctant to do so. Krueger's proposal merits further study, but some of the more evolutionary, piecemeal changes in international debt-restructuring arrangements, which I discussed under the general rubric of private-sector involvement, probably represent a more realistic hope for near-term improvement in international bankruptcy arrangements.

What Is Left To Be Done?

I have outlined some of the main efforts to prevent or mitigate financial crises in emerging-market economies. Now the question arises--What are the main tasks that remain to be accomplished? Many of the initiatives that I have discussed, such as formulation of standards and codes, reform of the international financial institutions, and development of procedures for private-sector involvement in debt restructurings, are processes that are already well under way and that have a momentum of their own. These areas do not so much need new initiatives as they do the extending, improving, and implementing of existing initiatives.

For the future, the main objective should be to improve economic policymaking and institutions in the emerging-market economies. All economies are subject to periodic external financial shocks. But these shocks are unlikely to turn into financial crises if the country experiencing the shock has a sound macroeconomic environment and robust, well-regulated financial institutions. It is hard to think of an emerging-market economy experiencing a crisis over the past decade in which preexisting financial market weaknesses were not a prominent feature. They certainly played a central role in the Asian financial crises of the late 1990s, and financial-sector reform was a key ingredient in the IMF programs that these countries entered. Though significant progress has been made in this regard, much remains to be done. In particular, sometimes governmental initiatives have been launched in areas such banking reform or corporate governance without sufficient followup. Once more stable financial-market conditions have returned, the hard work of implementing financial-sector reform has sometimes slackened. However, to the extent that significant financial-sector weaknesses remain, so too does the potential for future crises.

Economic crises in emerging-market economies usually manifest themselves in the form of financial-market pressures, but unsound fiscal policies are frequently at the root of the problem. An unsustainable fiscal position has often proved to be the main threat to financial stability. Fiscal problems were an important factor in the crises experienced by Mexico and

Russia in the second half of the 1900s and by Argentina currently. If market participants come to perceive high levels of government debt and continuing fiscal deficits as threatening a government's ability or willingness to meet its debt obligations, capital flight can be triggered. When the government's fiscal position is truly unsustainable, international financial assistance aimed at providing temporary liquidity will not suffice, and some form of debt restructuring becomes unavoidable. Thus, a sound fiscal position is as important as a healthy financial sector in preventing emerging-market financial crises.

We must be realistic about the feasible pace of improvement in economic policymaking in many countries. Economic institutions and practices take a long time to develop--they cannot be put in place or changed radically overnight. Furthermore, as I argued previously, efforts to introduce policies that open an economy to international markets before the appropriate legal and institutional infrastructure is in place--for example, taking all controls off short-term capital movements when the banking system is underdeveloped and inadequately regulated--can be counterproductive. Thus the importance of sequencing--of coordinating the timing of policy reforms with the evolution of supporting institutions.

Some of the changes in the international economic environment in recent years appear favorable to a reduction in the likelihood of financial crises in emerging-market economies. Although it is difficult to generalize, macroeconomic policymaking in emerging-market economies seems to have improved somewhat in recent years. The trend toward adoption of more flexible exchange rate regimes has already been mentioned. Also, over the past decade policymakers in emerging-market countries seem to have developed a heightened recognition of the costs of high inflation, as evidenced by the general reduction of inflation rates in such economies over this period. The behavior of investors in international capital markets appears to have evolved in ways that make future financial crises somewhat less likely also. The composition of international capital flows has shifted toward relatively more foreign direct investment and longer-term portfolio investment and relatively less flows into shorter-term "hot money" investments. Also, international investors seem to be differentiating more clearly among emerging-market economies, as indicated by the current wide dispersion of debt spreads across countries. This situation could mean less potential for serious contagion if one country gets into trouble, since there would be a reduced tendency to treat all emerging-market countries alike. The so far minimal financial market spillover to other emerging-market economies from the current difficulties in Argentina and Turkey is consistent with such a trend. Furthermore, to the extent that international investors have differentiated among emerging markets, countries have incentives to improve the availability and quality of their economic data as a way of favorably distinguishing themselves.

Conclusion
In conclusion, it is worth reiterating that the most important consideration in preventing future emerging-market financial crises is establishing sound domestic policies and robust financial institutions in individual economies. No reforms of the international financial architecture can, by themselves, overcome deficiencies in these critical areas. However, an incremental contribution can nonetheless be made through improvements in the international financial system and in international institutions. Such initiatives can provide information, incentives, and assistance to emerging-market economies to encourage them to adopt sound policies and can mitigate the damage to international financial markets when problems do arise. A number of such initiatives are under way, and they hold the promise of reducing the incidence and severity of emerging-market financial crises in the future.