SPEECH

Progress toward Financial Stability in Emerging Market Economies

October 4, 2006

Timothy F. Geithner, President and Chief Executive Officer

Remarks at the W. P. Carey Global Leader Lecture, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University, Washington, D.C.

Listen to speech OFFSITE

We are approaching the 10-year anniversary of the financial crises of the late 1990s. These crises began in the emerging world and caused very substantial damage to the economies and financial systems of a large number of emerging market economies. They also provided the backdrop if not the catalyst to the crisis that hit the major financial centers in 1998.

The world today looks considerably different than it did on the eve of those crises, but the episode still looms large in the minds of policymakers and financial market participants. The damage and fear of that time had a substantial impact on behavior, both in terms of the policies of governments and how market participants think about and manage risk. And those changes in behavior have been important contributors to the period of stable real growth and financial sector resilience that has characterized much of the world since.

Despite this progress, the causes and implications of the crises remain the subject of contentious debate. In fact, if you'd fallen asleep in early or late 1998, and awakened in the IMF boardroom yesterday, you would find officials discussing many of the same questions.

Were the crises the result of fundamental economic and financial weakness at the national level, or the result of forces largely beyond the control of governments in emerging market economies? Can small open economies grow and prosper with open capital markets and floating exchange rates? Did moral hazard induced by the success of the Mexican package earlier in the decade cause the buildup in lending that led to crises that followed? Did the initial response of the IMF and its creditors make the crises worse? What level of insurance, in the form of reserves or debt structure, is adequate to protect against crises? How should the IMF differentiate between conditions of illiquidity and insolvency, and decide when it should help a member country restructure its debt obligations?

Even among people who probably agree on the most important issues in economics and finance, you can still find stark differences in their answers to these questions. The diversity in the circumstances of the countries involved, and in the policy responses adopted, makes it easier for people to find evidence to support fundamentally different views. But even if we don't have enough experience or enough distance from the crisis to resolve these questions definitively, we know a lot more about these questions than we did a decade ago.

I want to talk about two dimensions of this broad policy debate. How much progress has been made toward addressing the factors that made emerging market economies so vulnerable to crises in the past? What are the most important policy challenges ahead for those governments? These are my personal views.

I should start by noting that your view on what constitutes progress is naturally shaped by your view of the factors that rendered emerging economies most vulnerable to crisis in the first place. While no broad characterization can do justice to the different conditions at play, I believe the available evidence supports the view that the crises were generally most acute where there was a large buildup in short-term external debt, encouraged by the presence a fixed exchange rate regime and perverse incentives in the capital account, tax, or supervisory regimes.

In most cases, these balance sheet weaknesses left the economies concerned acutely vulnerable to adverse shifts in confidence and the inevitable break in exchange rate regimes, with little flexibility for macroeconomic policy to cushion the damage. As domestic and foreign investors rushed to reduce exposure to the country, the exchange rate fell further, increasing losses for the banks and corporations that had borrowed in dollars and magnifying fear of default. Monetary policy did not get traction quickly, in part because the authorities were worried that producing higher real interest rates to stem the decline in the exchange rate and offer a higher return to attract flows back into the country would exacerbate the confidence problem, by causing a deeper contraction in growth.

In some cases, a history of high inflation, fiscal profligacy or default magnified the difficulty of restoring confidence. In almost every case, this dynamic was exacerbated by political conditions, a looming election or leadership succession that raised uncertainty about the competence and credibility of future economic policy.

Things look dramatically different today. If you compare an aggregate or typical emerging market balance sheet today with the equivalent from a decade ago, the improvement is striking in a number of dimensions.

Current account balances have gone from substantially negative to positive. External debt has fallen as a share of GDP. Reserves have grown to remarkable heights and are now a substantial multiple of short-term external debt, annual external debt service, or other traditional metrics of the scale of potential claims on reserves.

Public debt burdens are higher, but the composition of debt is less risky, with longer maturities, a greater share denominated in the currency of the sovereign, and more fixed rather than floating interest debt. Fiscal balances have improved, with the median deficit the lowest it has been in three decades, and the high public debt countries are running primary surpluses large enough to stabilize if not reduce the debt-to-GDP ratio.

Exchange rate regimes are more flexible, removing the implicit guarantee in a fixed regime and providing greater independence for monetary policy. Monetary policy frameworks have matured, with greater institutional independence for central banks. Better monetary policy, along with improvements in fiscal balances, have helped to bring about a dramatic reduction in inflation and the volatility of inflation rates in emerging economies.

It is hard to look at this record and find support for the argument that the financial resources deployed by the IMF and the major economies in the crises produced a damaging degree of moral hazard—moral hazard in the form either of governments more prone to profligacy or investors prone to excess risk-taking in lending to banks and sovereign in emerging markets because of the expectation of financial resources from the IMF. Of course, those interventions must have produced some increase in moral hazard, but the effect on incentives does not seem to have been powerful relative to the countervailing effect of the economic and financial losses incurred in the crises.

These changes in policies, and the reduction in external vulnerability that they have brought about, make it less likely that financial market shocks will trigger the types of acute, broad-based crises we saw in the late 1990s. The combination of less balance sheet exposure to exchange rate changes, less refinancing risk in debt structures, stronger fiscal and financial cushions, a large stock of reserves available to absorb shocks, and more flexibility for policy means that future sudden changes in financial flows should not precipitate the damaging runs on the financial assets of the country that they have in the past.

Ultimately, this should mean that volatility in capital flows will cause less damage to real economic outcomes in emerging markets. The declines in real GDP associated with emerging market financial crises have been alarmingly large. In the crises of the late 1990s, the ensuing contraction in real GDP exceeded 10 percentage points in some economies and approached 20 in others. If the progress we have seen over the last several years is sustained, the incidence of financial crises in emerging markets will be lower, and the dynamics significantly different. Where these balance sheet improvements are most advanced, future financial distress will look more like what we typically see in instances of financial stress in the major economies—substantial asset price volatility and the potential for substantial financial losses, but less in the way of a significant disruption to either short-run or long-run real economic growth.

This is of course a probabilistic judgment, not a certainty. The strong growth performance and greater financial resilience of emerging market we've seen this decade provides some support for this judgment. But, some of this progress was undoubtedly facilitated by the relatively favorable economic and financial conditions of the global economy and only time will tell whether it will prove robust in circumstances of greater macro adversity.

Of course, these broad trends in balance conditions mask substantial differences across countries. There is wide dispersion around the typical or average balance sheet I have described, and some important areas of vulnerability remain. Many countries still face daunting fiscal problems and are only beginning to be able to issue debt in their own currency at longer maturities. The political consensus that provided support for these improvements looks vulnerable to challenge in many countries. For a number of countries, improving financial strength will have to remain at the top of the hierarchy of policy priorities. And even where progress has been most impressive it could be eroded quickly.

Where progress has been made in reducing important sources of financial instability, policymakers in emerging markets have the opportunity to focus more effort on reforms that can help achieve and sustain higher growth in the future and on developing an institutional infrastructure strong enough to serve as the foundation for further integration into the global economy. This shift in focus brings with it of course a daunting array of complex economic policy challenges.

These challenges lie less in the types of things that can be captured in a financial ratio or balance sheet, or in changes to the risk premiums attached to the financial claims on the country. They lie more in the realm of improving how markets work and how efficiently resources are allocated. These factors include the development of the types of institutions that are the subject of DeSoto's work or the World Bank's Doing Business OFFSITE reports. They involve the development of the legal system and its ability

to ensure that property rights can be established and that the protections they engender can be enforced. They are about creating the conditions for more competitive domestic financial and product markets by reducing barriers to starting and building a business, and by building better transportation, power and telecommunications infrastructure. And they are about broadening access to and improving the quality of public education.

Allowing competitive pressures to operate is undoubtedly the best way to foster the investment, innovation and risk-taking that is central to raising an economy's long-run sustainable growth rate. But markets can't solve all problems, and they don't always function perfectly. This means that the policy imperative isn't simply to reduce regulation; it is to improve the design of the regulations that are important to dealing with market failures. Finally, future growth outcomes will depend importantly on the success of governments in fostering the development of the domestic financial system. This requires not only stronger financial intermediaries and better supervisors, but deeper and more liquid capital markets that provide greater access to capital for firms and greater freedom for households to borrow and to invest their savings.

Certain features of today's emerging economies, notably the size of current account surpluses and the high levels of reserves, tend to be seen principally as sources of comfort against future crises. But you can also look at these phenomena as measures of the incompleteness of the institutional changes achieved in the monetary and financial arena, and as a sign of the persistent ambivalence in the emerging world about financial integration.

The current account surpluses are, of course, the mirror image of the high rates of savings relative to investment. There are a range of factors that affect the flows of goods and services across international borders, but the sustained outflow of funds from some emerging economies witnessed in recent years may have as much to do with the limited intermediation capacity of the local financial systems as with the scarcity of profitable domestic investment opportunities. And in this sense you can read a large current account surplus as a sign of financial sector under development rather than of financial strength and maturity.

The pattern of intervention in exchange markets and the scale of reserve accumulation provides a similar perspective on the challenges ahead. Policymakers in many emerging markets still reveal a substantial degree of reluctance to allow the exchange rate to adjust to market forces. Part of this is aversion to appreciation, and part of it aversion to variability in the exchange rate. In this sense, the high level of reserves today could be read less as an indication of fundamental strength than as an indication of the need for more progress toward completing the transition to a modern monetary policy regime. Even though reported inflation in most emerging economies has been moderate, the observed preference for nominal exchange rate stability suggests a monetary policy regime with less independence to sustain price stability over time.

Emerging market economies have retained controls on cross-border capital flows, some quite comprehensive, some more selective. These come with a range of different justifications, from insulation against volatility and speculation, to protection of the domestic financial system, to limiting variability in the exchange rate or maintaining a specific objective for the level of the exchange rate.

By design, these controls limit the degree of integration with the global economy and they necessarily distort incentives in ways that affect all economic and financial activity. Their appeal as a source of durable stability has diminished over time, and we now have a greater understanding of the effects they can have in lowering long-run growth potential. For policymakers in many emerging economies, the question is not whether to remove controls, but when and how to do it without significantly raising short-run vulnerability to financial instability.

When it comes to undertaking reform in the areas of financial system development, the exchange rate and monetary policy regime, and liberalization of the capital account, there is more consensus on the importance of the efforts than there is on the appropriate pace and sequencing of policy changes. These initiatives are all closely related, and designing sensible reforms in one of these areas requires careful consideration of how to proceed with the others. Progress in one requires progress in the others. And market participants and policymakers need to have the chance to adapt to change and learn as reforms are implemented.

This is the classic and persuasive argument for care and for gradualism. But it is possible to move too gradually. There is risk in inertia as well as in change. The policy challenges in occupying the middle ground—the middle ground of trying to allow some but not too much variability in the exchange rate, some but not too much freedom for capital movements with the inevitable increase in leakages around the remaining controls, and some but not too much competition in a still fragile domestic financial system—may be harder during a protracted transition. The more protracted the process of agreeing on and initiating change, the greater the costs for the economy as a whole of the distortions left in place. By outlining a path for reform, governments can dispel uncertainty about the overall strategy and enable market participants to begin to adjust, mitigating some of the concern about moving too quickly.

Governments, perhaps governments everywhere, are probably behind the pace of integration that the market is driving in terms of further integration. This should provide a powerful incentive for greater speed and ambition in developing the institutional infrastructure that can accommodate the challenges that come with integration.

Overall, however, the direction of change in the emerging world seems fundamentally reassuring. After a crisis that was in a sense

the result of a failure to manage the early stage of financial integration, governments in emerging markets have established a record of credible fiscal and monetary policy management, built more substantial cushions of insurance against potential shocks in external reserves, restructured the currency denomination, maturity and composition of their debts to make them less vulnerable to volatility, and begun to build deeper and stronger domestic financial systems.

These changes make it more likely that the progress now underway toward further financial integration—as they move to more open capital markets and more flexible exchange rate systems—will bring substantial benefits in terms of growth and fewer risks in terms of financial stress. The stronger foundation now in place will make the next wave of financial integration more successful.

The policy achievements of the last decade are enormously consequential for the people who live in emerging markets. If the progress is sustained, the reduced vulnerability to financial crisis and the enhanced efficiency of resource allocation have the potential to dramatically increase long-run growth and living standards in these countries.

And of course the United States, and the rest of the world, has compelling strategic and economic interests in the success of this endeavor. A more complete and successful integration of the emerging economies offers the prospect of a more prosperous and stable global economy.

Thank you.

I would like to thank Matthew Higgins of the Emerging Markets and International Affairs Group and Margaret McConnell of the Research and Statistics Group at the New York Fed for assistance and comments.