General Discussion: Role Reversal in Global Finance

Chair: José De Gregorio

Mr. Redrado: The most significant challenge policymakers have in emerging markets is how to deal with (and manage) capital flows. The world is in a very fragile place right now, so clearly the insurance against sharp capital movements is becoming critical.

I have done research and written on reserve accumulation. Looking at a panel model of Asian and Latin American countries, what I found is that inertia behavior, regional imitation, both trade and financial openness, are important factors driving reserve hoarding. In the context of asymmetric financial integration, reliance on international liquidity is a feasible way of guaranteeing stability of monetary and exchange rate policies when real and financial shocks are faced. This is critical to show that this is not a sporadic policy, but a more permanent one.

But if you want to change the role reserve accumulation has had in terms of the financial crisis and smoothing capital movements to a kind of insurance policy, as you are proposing, I would argue that you need a set of objective and specific criteria to monitor the capacity that countries have to repay that insurance. You need to establish a set of quantitative ratios that will make this an objective criterion. For example, ratios such as international reserves to M3, international reserves to short-term debt, bank loans to bank deposits, and so on. You need to think about a kind of credit scoring system that looks at cash flow of public and private sectors. A more specific criterion would benefit the development of this insurance policy. It would not carry any preconceptions about the definition of sustainable policies. So, a set of specific quantitative macroeconomic ratios should be the criteria to make this insurance available for all countries. If not, emerging economies will prefer to continue with these policies of reserve accumulation.

Mr. Bergsten: Eswar's paper certainly has a lot of creative analysis and ideas in it but he glosses over the central issue about the reserve buildup when he says, "We don't really know whether it's mercantilism or an insurance objective."

His numbers show China alone is half the issue: half the buildup of foreign exchange reserves and, if we add a few countries around China that follow similar polices, the number is well more than half the problem he is trying to address. In the case of China and those associated countries, there is no question what the motive is: It is mercantilism. No one can think that beyond $3 trillion there is any insurance motive at all. China intervenes to the tune of about $2 billion every day in the foreign exchange markets in order to keep its exchange rates substantially undervalued for mercantilist reasons. And note, despite the appreciation of the RMB against the dollar in recent months, the RMB still has not appreciated at all—repeat, has not appreciated at all—on a real effective basis. So the mercantilist objective is there.

The question is then what to do about it. When China complains about the possible risk to its dollar holdings, the issue Eswar raises, the answer is very simple: Stop buying dollars.

The Chinese say, "We worry about the international value of the dollar." My response is always, "But you are building up $2 billion a day more of global dollar assets. You are the main perpetrator of an increased reserve currency role for the dollar. Your concerns cannot be accepted."

An insurance pool could be useful for some, perhaps smaller, countries, as Susan said, where insurance is the major goal. But I would hate to see an initiative of an insurance mechanism, of the type Eswar proposed, deflecting attention from the bulk of the problem and the need to continue to focus on the underlying imbalances.

Mr. Toukan: I really had two brief remarks, which relate mostly to the previous session. Due to the shortage of time, I didn't have the good fortune to say them.

Now, the first remark really relates to the role of central banks as bank regulators. The global crisis has shown clearly regulators should be smoke detectors, as opposed to firefighters. Although major central banks had to do a lot of firefighting during the crisis, banks in our region and probably in one or two other regions did very well during the global crisis, or were not affected to any appreciable extent by the global crisis due to the fact we strictly implemented international standards in terms of prudential regulations—the Basel Accords, best practice standards, benchmarks, and others. Which leads me to my second remark, that very valuable research has been presented to us on regulated regimes or oversight regimes, but almost in isolation of the international dimension in the previous session.

Today we speak of multilateral IMF surveillance and we speak of spillover reports. I believe I mentioned last year during the final session that a major challenge, which continued to face the global community, is how to reconcile the national interest with the international or global interest. This is still valid, in general, but also as it relates to bank regulation regimes across countries.

As far as the presentation we just heard, which is excellent by the way, I agree with Fred Bergsten that it missed the main point. If global imbalances are to be addressed in any effective manner, savings behavior, and consumer behavior in major economies should change, so surpluses would move to deficit countries. This points to a basic criticism against the Bretton Woods system, namely, there is no mechanism that forces surplus countries to adjust. The intervention referred to $2 billion a day to maintain an undervalued exchange rate suggests that practices of this sort are not consistent with the interests of the global community.

Mr. Wilcox: Fred Bergsten anticipated one of my remarks, so I'll avoid repeating that. The second issue I wanted to raise could be just a semantic issue with the word "insurance." I wanted to do that by appealing to a couple of lessons that came out of the recent financial crisis.

Insurance sometimes creates an image of pooling of risk, but one general phenomenon was, in times of crisis, correlations go to 1. So that has a couple of implications for the viability of the proposal here. One is whether there really is any true insurance. It could be a useful construct to have an ex ante institutional arrangement, but I am not sure "insurance" is the word I would attach to it.

It also seems to impugn the viability of having a capitalization of 5 cents on the dollar, if everybody is drawing on the capacity all at once. It could be that this is useful for idiosyncratic events. But one of the lessons of the last few years is that we also have to make preparation for something which is systemic as well.

Mr. Gudmundsson: This is a quick comment and question relating to Eswar's plan to save the world, which I like up to a point, but it needs more work.

One of your ideas that I am wondering about is that this would imply an institutionalization of the swap lines, but I have my doubts about that. The swap lines were all about lending to banks and extending the lender-of-last-resort arm of the Fed across the borders. It was very effective when they were uncapped, but this will be capped. There is a distinction between lending to banks and sovereigns that needs to be thought about.

You state the insurance mechanism should be restricted to major economies. My question is, Why is it restricted to major economies? For it to be effective, it should be as universal as possible. Through this proposal, are you not letting in the back door the issue of who is going to decide what is a major economy and a minor economy? So please think about that.

Mr. Kganyago: Something that struck me in the paper is the concern about countries investing their reserves in advanced economies and the debt metrics of the advanced economies deteriorating. Then you add the proposal of the insurance mechanics and the pool being invested in the debt of advanced economies. That sounds contradictory to me, because it reinforces what we are currently having as reserve currencies. The big question we should be posing is, Is there scope for other currencies to play the role of being a reserve currency?

The second point I wanted to raise flows from an earlier speaker, which had to do with characterizing this thing as insurance. Maybe we should find some other name. Why is it called insurance when I pay a premium, then when I have to meet the short event, it comes back as a loan? The characterization of this as insurance does not seem to hold and we should not be calling it that.

My final point has to do with the notion of the IMF carrying a stigma of some sort. I don't know where this is suddenly coming from, because we are again missing an important point, which has to do with the legitimacy of the IMF. If the issue is the legitimacy of the IMF, let us deal with the issue of the legitimacy of the IMF instead of saying, "Well, maybe this organization should be located elsewhere." If we confront the issue of the legitimacy of the IMF then we will actually be dealing with the issue.

My question to Eswar is, Do your calculations of debt flows to emerging economies include domestic currency-denominated debt?

Mr. Lipsky: I have a couple of quick comments. I agree with many of the comments that already have been made. One is to remember the increase in flows to emerging markets has reflected, more than anything, the underlying improvement in the fundamentals of those countries, including declining debt ratios, declining inflation, increasing openness, liberalization, etc. That is much more important in determining flows than anything like the existence of reserves.

Secondly and importantly, the format of those flows, as your paper points out, has shifted very substantially, as we all know, away from bank-based financing for intermediating flows to emerging markets in the 1970s and early 1980s to portfolio flows. It is worth noting, however, in FDI flows that a substantial portion of FDI is retained earnings. As a result, it is a bookkeeping entry. The apparent stability of FDI, in some cases, represents tax advantages in the host country. So the stability of those flows is probably exaggerated in statistical views.

The move toward a securitized format for cross-border flows has changed the needs and methods for stabilizing flows. One thing worth noting is, from the point of view of the recipient, these are viewed in flow terms with the goal of stability. From the point of view of the investor, this is viewed in a stock-adjustment form. As a result, it is not so surprising these flows can be a bit lumpier than would be desired from the host's or recipient's point of view.

The development of increasing the depth of domestic financial markets should reduce the concern over the volatility of these flows. In this context of a move toward securitized finance, of course, and the desire to provide crisis-prevention facilities—like insurance facilities—as you note, the IMF developed the flexible credit line (FCL), which is our first prequalified facility designed exactly to provide liquidity for countries that are following good policies.

You state the IMF can't provide insurance, because programs to prequalify countries carry stigma. In fact, we have present officials from three countries that have used the FCL—Poland, Mexico, and Colombia—and in each case facts show the stigma has been positive. In other words, use of the FCL improved market access, reduced spreads, and was favorable for those countries. So the assertion of stigma is an opinion, but the facts show otherwise.

Now to the question: Your proposal of an insurance program you say gets away from the political problems, but the heart of the issue becomes how the insurance program will conduct surveillance to judge the quality of policies. In other words, it is not obvious to me this gets away from the alleged source of the problem, represented by the IMF, in any fundamental way, but rather pushes it off into some unspecified format.

Mr. Padoan: I really enjoyed the paper and the comment from Susan. I have two quick points and a question.

The first point relates in part to what John just said about what drives capital flows and their composition. What we have done at the OECD is look at the correlation between the size and composition of capital flows and structural policies, irrespective of whether these policies were adopted for capital account purposes. What we find is that growth-enhancing or productivity-enhancing reforms, which I explained yesterday are the most needed in emerging economies, are a major responsible for the shift toward FDI and away from debt, which matches your evidence. So the first point is, as we think these countries should do more in terms of productivity-enhancing measures to boost growth, we would see possibly a reinforcement of the pattern you have described.

The second point is, of course, we all like to think in the long term a virtuous international capital market integration exists, where all imbalances are good imbalances and not bad imbalances. But maybe this is not going to happen. We are going to see periods of financial market's instability in the international domain.

We have seen recently, that in a number of emerging markets have been receiving "excess liquidity inflows," which have produced a number of problems and of reactions, including prudential measures and, in some cases, "capital controls." This issue will remain. If we are moving toward more integration, but perhaps also more instability, we need to face the challenge of allowing countries to deal with emergency situations, but at the same time preserving the long-term overall market openness. So you need rules to do that. Let me remind you, if I may, there is something called the OECD Code of Capital Account Liberalization, which is open to non-OECD countries as well and provides a framework to help countries take their individual measures but at the same time preserve the international open market approach in the long term.

Then my question, which is my first and last, to Eswar in particular, in discussing your insurance proposal—I will not comment on it —you did not mention anything about possible regional agreements. What is your view about regional insurance, or whatever agreements you want to call them, as possibly a transition phase toward a more global approach?

Mr. Prasad: Thank you for those comments and especially to Susan for her very thoughtful reframing of the issue. I advertised my proposal as "saving the world." That may have been a touch immodest.

The question is how to think about what brought us to where we are right now. It is very important to think about the fact that what happened in the crisis has accentuated the incentives of reserve accumulation. It is very hard to separate out these motives and I don't even intend to try to do so. Even if one thinks about non-China emerging markets and I don't mean to restrict this to the large emerging markets, I think any country can participate, but there are some countries that need development assistance and assistance with solvency problems and I don't think this scheme is right for them.

Ultimately there is an important general equilibrium issue here that, so long as the emerging markets feel the need for more protection and feel there aren't institutional mechanisms in place that can provide the sort of protection they need, the situation that was referred to in terms of the dependence on their dollar and in terms of the way the international monetary system is structured is going to remain. This won't solve the problem entirely. It won't solve dependence on the dollar in the reserve currencies areas. But, at the margin, it can have a very important effect in terms of protecting the emerging markets—and as Susan very nicely put it—depoliticizing access to liquidity, which is really crucial and getting us away from some of the basic issues that brought us to where we are in terms of the structure of the international monetary system.

In considering the insurance mechanism itself, first of all it is not a traditional insurance mechanism, it is true. As David Wilcox pointed out, it is not a pooling of risks, because when these risks hit, they are going to be common. That doesn't take away from the fact, from an individual country's point of view, it is just trying to have insurance against a macro event.

The mechanism I have in mind for backstopping the insurance pool with major central bank credit lines is not new, but what it is doing–and this is very important—is taking what happened ex post in the middle of the crisis, and setting it up ex ante. This in itself has a very significant effect. To paraphrase Hank Paulson's statement, "If you have a large bazooka in your pocket, it is much less likely you'll have to use it."

That is the sort of spirit we should see this in. If crunch time comes, ultimately there is going to have to be an ex post mechanism in order to provide liquidity to countries that get hit. One can talk about the fine details about whether this is provided to sovereigns or to banks. The reality is having this pool of credit is what countries are after. This helps in a very important way.

Why can't the IMF do this? It is true the IMF has been very forthcoming with the Flexible Credit Line, to which three countries have signed up, and the Precautionary Credit Line, to which tiny Macedonia has signed up.

Again, the issue here is the big systemically important countries are not signing up. Mexico found this very useful and often the countries that had experienced very significant reserve losses that I list in the table such as Mexico and Poland are indeed interested. But there are a whole lot of other countries that do not seem to be at all interested in the Flexible Credit Line.

What I am suggesting—and this goes back to John Lipsky's point about the surveillance—what this mechanism will do is free up the IMF to do what it does best. Having worked there, I can attest that the real strength of the IMF is to do surveillance. Once you separate out these functions, the surveillance function and the crisis lending function to countries that are insolvent, those are the IMF's real forte, rather than providing ex ante insurance.

In fact, I think this would make the IMF much more effective and much less politicized. This proposal to "save the world" is relevant for an imperfect world. If you could have the IMF having ultimate legitimacy in the eyes of the emerging markets, if you could set up a mechanism whereby the IMF could somehow unconditionally guarantee that ex ante conditionality would not turn into different forms of exposed conditionality, then we would be OK. We are very far from that world. So this is a proposal to save a very imperfect world.

The objective and specific criteria are essential. There is a question of how complicated one wants to make this mechanism. In this paper, I had enough detail but I didn't want to flesh out each of the issues about how to set up the precise premiums. Again, this is a pool that would be run by the large economies. They would ultimately have to set it up. The G-20 has shown it can do certain things.

This is not going to be an easy thing to do, but once we can come up with a set of criteria—I mentioned a few in the paper that can easily be expanded (levels of deficits, debt, amounts of external debt, and a few other things)—setting up a premium structure is not going to be intractable. The insurance would not have a standard pricing structure, because we aren't looking at a pooling of risks, but the principle of getting riskier borrowers and borrowers who remain risky for longer time periods is relatively easy to deal with.

Ms. Collins: It seems to me there are many additional issues raised about the proposal. I wanted to sign on to the questions that were raised. We don't have time to address them. It seems this is exactly the kind of conversation that is important to try to move things forward. I must say I am more of a proponent of trying to figure out how to address the issues and challenges in the institutions we currently have and are already in the process of setting up new ones with the G-20 and with the global Financial Stability Board, as opposed to creating additional institutions at this point that, in some complicated ways, would have to build on and draw from those other institutions. For example, using the IMF for surveillance in order to implement this scheme strikes me as challenging. Again, I think it is an important conversation and I look forward to continuing it.