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# Reforms to global financial architecture

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In recent years, and particularly since the Asian crisis of 1997/98, much international attention has been directed at proposals to reform aspects of the international financial system – the so-called “global financial architecture”. This article outlines the concerns underlying the international financial reform proposals and summarises their key objectives and elements.

## 1 Introduction

The last three years or so has been a period of reconsideration of several elements in the international financial system. The review process was initiated in the context of the Asian crisis of 1997/98 and other episodes of financial and economic instability, in an attempt to identify measures to reduce the risk of future instability and promote a more effective means of resolving financial difficulties when they do arise. Many of the reforms identified are still under way and in some cases are likely to take several years to implement.

Given the potential importance of reforms to the international financial system, and the implications for national economies, including that of New Zealand, it is useful to promote greater public understanding of the issues involved. This article seeks to do that by explaining the context in which the issues have arisen and summarising the main elements of the reform proposals.

As we observe later in this article, there is much of value to be extracted from the proposals. But, at the same time, the collection of measures does not yet live up to the label that the international community attaches to it and that we have reported in the title of this article.

Section two of the article sets out the principal concerns that have given rise to the proposed reforms of the global financial system. Section three discusses the policy objectives underlying reforms and the policy responses being pursued to meet these objectives. It then summarises the key elements in the main policy initiatives. Section four discusses in general terms some of the implications for New Zealand arising from the international financial reforms. And section five draws together some concluding thoughts.

## 2 The concerns underlying international financial reforms

Interest in reforming elements of the international financial system were triggered by a number of concerns, particularly those arising from the financial and economic instability experienced in parts of Asia and Russia in 1997/98. The main concerns are summarised below:

### Financial liberalisation and cross-border capital flows

One of the principal concerns relates to the process of financial sector and capital account liberalisation and the risks that can arise after a period of rapid liberalisation. In particular, there has been a growing awareness that rapid liberalisation, and the associated expansion of credit and increase in the mobility of cross-border capital, can give rise to significant risks unless liberalisation is preceded or accompanied by measures to promote more effective risk management.

One of these risks is the potential for large capital inflows to be poorly invested, resulting in a misallocation of resources, which in turn can reduce the growth capacity of an economy and distort asset prices. For example, in a number of countries, rapid financial and capital account liberalisation, unsupported by sufficient strengthening of the management of risks, resulted in a sharp increase in commercial property and equity-related investment. As a consequence, commercial property and equity prices rose to levels that subsequently proved to be unsustainable. The eventual correction in these prices contributed to a sharp deterioration in the asset quality and financial performance of the financial and corporate sectors. In some cases, the deterioration was so severe that large numbers of banks and other corporate

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entities became insolvent, leading to widespread financial instability.

This was one of the features in the Asian crisis over 1997/98. But it was by no means unique to Asia. Similar dynamics have arisen in many other countries over the years following periods of rapid liberalisation, with severe consequences for financial stability. Notable examples include the severe financial instability in parts of Latin America in the 1980s and 1990s and in Scandinavia in the late 1980s. And New Zealand has by no means been immune to these difficulties, having experienced significant financial system turbulence in the late 1980s, in part as a result of poor quality lending decisions in the wake of rapid financial liberalisation.

Another key concern relating to cross-border capital flows has been in relation to the causes, dynamics and consequences of sudden outflows of capital. In recent years there have been several examples of financial crises developing in association with sharp reversals of capital inflows. While the causes and dynamics vary in each case, common features typically include the following:

- Overseas (and domestic) investors withdraw capital in the face of actual or perceived adverse economic or financial events. These can include concerns over potential financial or corporate sector instability, perceptions that a country's currency is severely over-valued, or concerns over the direction of economic policy. And the degree of capital flight can be increased as a result of market dynamics, including a tendency in some cases for investors to display "herd behaviour" (in part because of deficiencies in available information). As discussed later in this article, concern has been expressed about currency speculation and attempts at market manipulation by hedge funds and other market participants, which it is argued also have significant effects on market dynamics and capital flows, and contribute to exchange rate pressures.
- The withdrawal of capital, if sufficiently severe, has the potential to cause or exacerbate financial instability by placing liquidity pressure on financial institutions and corporate borrowers, creating pressures on interest rates, and potentially threatening the solvency of bank and non-bank borrowers. Financial instability is more likely

to arise where there are already points of fragility in the financial system, as was the case in a number of Asian countries in 1997/98. In particular, financial instability is often associated with excessive exposure concentration, large exposures to related parties, poor asset quality (reflecting inadequacies in credit risk management), inadequate levels of liquidity within the banking system and a low level of capitalisation.

- In situations where an economy operates under a pegged exchange rate, capital withdrawal has the potential to place severe pressure on the exchange rate, and in extreme cases can result in an abandonment of the peg and a substantial decline in the currency. In turn, this can have adverse effects on financial stability by exposing local financial institutions and corporates with unhedged foreign currency debt to losses and by triggering a sharp increase in interest rates. This was an important element in the financial instability of some Asian economies in 1997/98.

The concerns in relation to financial liberalisation and the potential volatility of cross-border capital flows have given rise to a number of proposals for reforms, as discussed later in this article.

### **Weaknesses in economic and financial policy and transparency arrangements**

Another factor underlying proposals to reform the international financial system relates to weaknesses in economic and financial sector policy and transparency arrangements. This recognises that most episodes of financial crisis are in part a result of weaknesses in economic and financial policies, including:

- deficiencies in monetary, fiscal and exchange rate policies (including poorly specified and sometimes conflicting policy objectives, and policies that are not sustainable or credible in the eyes of investors);
- weak transparency and accountability arrangements for economic policy;
- poorly developed market disciplines in the banking and corporate sectors, often as a result of government ownership of financial institutions or the presence of government guarantees (implicit or explicit);

- deficiencies in corporate governance arrangements applicable to the banking and corporate sectors (particularly in terms of the role of directors, accountability structures, management of conflicts of interest, and risk management systems);
- ineffective regulation and supervision of financial institutions (and in particular, inadequate structures to encourage prudent levels of exposure concentration, connected exposures and asset quality);
- inadequate accounting and auditing standards and ineffective enforcement of these standards; and
- deficiencies in insolvency law and mechanisms for effectively responding to corporate and financial sector distress.

These concerns have led to considerable attention being given to the development of structures for encouraging governments to adopt and maintain sound, sustainable and credible policy arrangements.

### Contagion risk

Recent episodes of financial instability have also given rise to concerns over contagion risk - the potential for the economic and financial difficulties of one country to cause or trigger difficulties in another. These concerns have grown in recent years as countries have become more interconnected in terms of capital flows, international ownership of financial institutions, and increasing trade linkages. These inter-connections can facilitate the transmission of economic difficulties from one country to another in various ways. For example, a financial crisis in one economy can affect others by reducing international trade, potentially inducing recession and instability on a wider scale. In addition, financial instability in one country, characterised by widespread bank failure or distress, can be transmitted to overseas subsidiaries or branches operating in other countries. Financial distress can also be spread to other economies as a result of liquidity pressures or investor caution arising in international markets in reaction to a financial crisis. This was a characteristic of the Asian and Russian financial difficulties in 1997/98, when, for a period after the initial unfolding of the crisis, sharply increased risk aversion caused liquidity pressures to emerge in international financial markets and bond spreads to widen

substantially. This made it difficult and expensive even for borrowers outside of the crisis-affected countries to obtain funds.

### Financial market manipulation

A further issue underlying aspects of the reforms relates to the role that highly leveraged institutions (HLIs), such as hedge funds, are said to have played in contributing to disruption in some economies' financial markets and placing pressure on currency pegs. These factors were reportedly a significant issue in the case of Hong Kong, Thailand and some other economies in the region in 1997/98, where HLIs and other market participants are said to have put pressure on currency pegs through trading strategies that involved overt attempts to influence market sentiment. There have also been concerns that HLIs can become so large that their collapse has the potential to cause significant disruption to financial markets and difficulties for banks and other providers of credit to HLIs. Reflecting this, much work has been undertaken in various forums to evaluate the risks posed by HLIs and to explore options for addressing those risks.

On the other hand, it is recognised that, while HLIs can pose risks for market integrity and stability, they can also bring potential benefits to markets, by promoting greater market depth and efficiency. And there is the potential for currency speculation to play a helpful role more broadly, by strengthening the market disciplines on policy makers to maintain sound and credible economic policies. Therefore, as noted later in this article, there is a need for a balanced assessment of the risks and benefits posed by HLIs before any firm policy conclusions are reached.

### Offshore financial centres

Some elements of the international reforms have also arisen from concerns over Offshore Financial Centres (OFCs) – financial centres where most of the financial activity conducted by participants is in respect of non-resident business. It has been argued in some quarters that some OFCs facilitate a range of illegal or unethical financial practices, including money laundering and tax evasion, and may pose a risk to the integrity of the international financial system. This argument arises because a number of OFCs in

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effect provide international financial institutions with opportunities to base themselves notionally in, or conduct business through, a jurisdiction where there are few regulatory constraints on their activities. In addition, there have been concerns in some cases that concessional tax arrangements and other favourable regulatory treatment offered by some OFCs have induced a diversion of capital flows into these jurisdictions on such a scale as to create difficulties for the efficient intermediation of capital inflows. In turn, this has exacerbated resource allocation and asset quality problems.

Reflecting these concerns, there has been increasing pressure for the surveillance of OFCs to be strengthened and for OFCs to come under increased pressure to comply with international standards and codes so that entities registered or notionally based in OFCs would be subject to standard international regulatory requirements.

### Role of the IMF

The IMF's role in responding to and managing financial crises has also been the focus of considerable attention. Some commentators have been critical of the IMF's handling of international financial crises. One of the key concerns has been that IMF rescue packages tend to weaken the disciplines on borrowing governments by immunising some private sector creditors from losses and by providing funds to defaulting countries on terms that do not create sufficient incentives for governments to take the necessary steps to avoid future crises. At the same time, however, it has also been argued that the IMF's policies have exacerbated recessions in the crisis economies, especially as a result of overly stringent fiscal policies. The IMF has also been criticised on the grounds that its own governance, transparency and accountability arrangements are inadequate and reduce the quality of its performance. For these reasons, a number of policy initiatives have been advanced in an attempt to strengthen the IMF's transparency and to make it more effective in performing its functions.

## 3 The policy objectives and responses

The types of concerns mentioned above have given rise to a plethora of policy initiatives, supported by a large and varied cast of international participants. The key players are the IMF, World Bank, and the Financial Stability Forum (a new international organisation formed in 1999 by the systemically important economies to coordinate initiatives in relation to promoting global financial stability). In addition, the international standard-setting bodies, such as the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), the OECD and the international accounting and auditing standard-setting bodies, are also actively involved in aspects of the international financial reform process. Regional forums, such as APEC and regional or ad hoc groupings of central banks and treasuries (the Manila Framework Group for instance), are also active in international policy discussions.

The objectives of the various initiatives under way include:

- encouraging the adoption of sound and credible financial and economic policies, and strengthening risk management within financial systems, through the development of international standards and codes and the provision of technical assistance to implement policy reforms;
- promoting greater transparency of economic policy and economic data, so as to strengthen the disciplines on policy makers and facilitate better informed decision making by investors;
- encouraging high quality and timely financial disclosure by public and private sector entities;
- strengthening the international surveillance of countries' financial systems and developing methodologies for assessing potential vulnerability to financial instability;
- reducing moral hazard risks in the resolution of international debt defaults by facilitating greater private sector involvement in debt default situations;
- reducing the risks associated with HLIs; and
- strengthening the effectiveness, transparency and accountability of the IMF.

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These are all appropriate objectives and, if achieved, would go some way towards promoting greater global financial stability and laying the foundations for sustainable economic growth. However, as discussed later in this article, there are limits to what can realistically be achieved. While it is possible to develop structures for reducing the risk of financial instability, and for better responding to episodes of financial distress when they do arise, it is not feasible to eliminate financial distress, and nor would it be desirable to try to do so. There is inevitably a trade-off between risk and return in every business decision and in every economy. Economic growth is not possible without some risks being taken. That being so, there is always the potential for economies to experience periods of difficulty and occasionally for this to create distress in the financial system.

Although the label “global financial architectural reform” is commonly attached to the collection of policy initiatives developed by these various groups, the main thrust is somewhat narrower. Essentially, these reform proposals focus on promoting structures and policies at the national level, to encourage greater understanding and management of risks, so that the incidence and severity of financial instability can be lessened. Even here, there is a limit to what can be achieved. Although international standards provide useful frameworks to assist national authorities in their approach to managing risks within their economies, they are not a panacea in themselves. Similarly, while strengthened international surveillance and vulnerability assessment may assist in promoting improved management of risks within economies, there is a limit to their effectiveness. At the end of the day, much of the real gain in promoting sound economic and financial policies will depend on policy makers at a national level developing their own understanding of the risks involved and reaching their own conclusions as to the policies needed to manage these risks. In some cases, the development of this understanding, and the internalisation of a commitment to implement the necessary reforms, occur only as a result of policy makers having experienced for themselves the consequences of inadequate economic and financial policies.

In the context of the above observations, the main international reform initiatives are discussed below.

## International standards

A major feature of the reforms to global financial architecture has been the development of a large number of international standards and codes covering a wide range of policy areas. Their purpose is to provide a framework for assisting countries (and particularly developing and emerging economies) to improve the quality of their economic and financial policies and transparency practices. The development of standards has become an international growth industry, with more than 50 new standards, codes and guidelines currently being developed by many different standard-setting bodies. The main areas being worked on relate to:

### *Transparency of monetary, financial and fiscal policies*

The key international bodies are promoting greater transparency in economic policy in order to strengthen the accountability of policy makers and to promote better informed decision making by investors. To assist in this process, the IMF has issued two transparency codes: one on monetary policy and financial regulation, and another on fiscal policy. The codes set out guidance on promoting effective transparency of the objectives, implementation and performance of monetary, financial and fiscal policies, and also contain principles relating to governance and accountability arrangements on the part of government authorities responsible for making and implementing policy.

### *Data dissemination*

The IMF is seeking to promote high quality, frequent and timely release of economic data by national authorities in order to promote better informed investor decision making and to strengthen disciplines on policy makers. To that end, it has produced two standards on macro-economic data: one for developing economies (intended to assist in the progressive development of systems for generating high quality data), and another for countries with well developed data arrangements (which prescribes specific data requirements, including the frequency and timeliness of dissemination).

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### *Banking supervision*

In recognition of the fact that banking system weaknesses have been a significant feature of financial crises, a key element in the global financial architecture reforms is the development of frameworks to strengthen banking systems and to promote more effective risk management capacity within them. In this context, a number of initiatives are under way to strengthen the supervisory arrangements applicable to banking systems. As part of this, the Basel Committee on Banking Supervision has developed a large number of codes and guidelines. The most important of these are the Core Principles for Effective Banking Supervision and the associated methodologies for assessing compliance with these principles. The principles cover a broad range of banking supervision issues and are intended to provide guidance to countries in the design and implementation of their banking supervision arrangements. They also provide a framework for assisting in IMF surveillance of countries' banking supervision arrangements and in the organisation of technical assistance programmes. In addition, the Basel Committee has released proposals for reforms to the Capital Accord, designed to strengthen and refine the capital adequacy arrangements for banks, and has also released guidance papers on a range of other matters, including corporate governance, internal controls and transparency.

### *Securities regulation*

The International Organisation of Securities Commissions (IOSCO) has developed a large number of standards, codes and guidance statements to assist securities regulators in the design and implementation of securities market regulation. Of these, the most important is IOSCO's Objectives and Principles of Securities Regulation, which sets out principles in relation to the key areas of securities market regulation and is being used as a framework for external surveillance of countries' securities market regulation by the IMF.

### *Insurance*

In order to encourage more effective supervision of risks associated with life insurance, a set of Insurance Supervisory Principles has been issued by the International Association of Insurance Supervisors. Like the other standards being

issued, these will form part of the framework for external assessments of countries' financial sector policies and will assist in the provision of technical assistance to developing and emerging economies.

### *Accounting and auditing standards*

A large number of international accounting and auditing standards have been issued by the International Accounting Standards Committee and International Federation of Accountants respectively. These standards provide guidance to national standard-setting authorities in the development of accounting and auditing standards and are gaining increasing influence in setting minimum benchmarks for financial disclosure.

### *Payment and settlement systems*

In recognition of the important role that payment and settlement systems play in a modern economy, both in terms of financial stability and in facilitating efficient commerce, various international agencies have prepared reports and guidance material to assist in the design and governance of payment systems. A recent addition to these initiatives is the Core Principles for Systemically Important Payment Systems, issued recently by the Committee on Payment and Settlement Systems. It sets out high level principles relating to the design of payment and settlement systems, including in relation to governance arrangements.

### *Financial crime and market integrity*

As a result of growing concerns about international financial crimes, such as money laundering and tax evasion, a number of measures are being promoted to strengthen the integrity of financial markets and combat financial crime. An important part of these initiatives has been the development of the so-called '40 Recommendations' by the Financial Action Task Force, which provide guidance to national authorities on measures to combat money laundering, and provide a framework for external assessment of countries' policies and arrangements in these areas.

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### *Corporate governance*

Another area that has received considerable international attention in recent years is corporate governance. This reflects the important role that corporations and other business entities play in national and international economies, and therefore the importance of frameworks to encourage sound governance arrangements, risk management systems and accountability structures in the corporate sector. To that end, the OECD has issued a set of principles on corporate governance, covering such matters as the duties of directors, the rights of shareholders and the importance of internal controls and financial disclosure. In addition, the World Bank and various other international forums (including APEC and the Commonwealth) have undertaken work in the area of corporate governance.

### *Insolvency law*

Various financial crises have demonstrated the importance of insolvency frameworks in the resolution of instability. Deficiencies in insolvency law, and a lack of capacity to administer insolvency and other debt default resolution arrangements, have exacerbated the extent of financial losses in some crisis-affected countries and impeded the quick resolution of debt default situations. In recognition of these problems, various initiatives are under way to promote the development of effective insolvency arrangements, particularly in developing and emerging economies. These include the development by the United Nations of a model law on cross-border insolvency and the release of a report on insolvency procedures by the IMF. In addition, the World Bank and other international bodies are working on an initiative to develop guidelines on insolvency law for application in developing countries.

In recognition that there has been a proliferation of international standards and codes, and that this may present difficulties for their implementation, the Financial Stability Forum (FSF) has attempted to promote greater prioritisation of standards. In this context, the FSF has prepared a Compendium of Standards and has identified a set of key standards covering 12 policy areas (as identified above). The FSF has also been exploring the options for encouraging the implementation of standards, including by the use of country

self-assessments, external assessments, technical assistance and the use of incentives. In the latter regard, the FSF has identified a number of possible incentives to encourage the implementation of standards, including:

- making membership of international bodies conditional on progress in implementing standards;
- linking market access to the observance of standards;
- imposing additional examination or audit requirements on entities based in jurisdictions that have poor compliance with standards; and
- restricting transactions with, or imposing higher risk weightings on, entities based in low compliance jurisdictions.

These are preliminary proposals and it remains to be seen which, if any, will be accepted by the international community. From a New Zealand perspective, the Reserve Bank is wary of the use of incentives to promote the implementation of international standards, particularly if this leads to an excessively prescriptive approach to their implementation. Although international standards provide useful guidance to assist national authorities in the design and implementation of policy reforms, they should not become rigid templates to be applied uniformly regardless of a country's particular circumstances. Rather, there needs to be a recognition that there are alternative ways to achieve desired policy objectives and that the choice of policy options will depend on many factors, not least the structure and circumstances of an economy and its financial system. In its interactions with international agencies, the Bank has therefore urged a more flexible approach to the design and implementation of standards, and has counselled against a "one size fits all" approach.

### **International surveillance**

In tandem with the development of international standards, there has also been increased emphasis on the role of international surveillance, with a particular focus on assessing countries' compliance with international standards and codes, and assessing countries' economic and financial vulnerabilities. In this context, two new surveillance programmes have been initiated:

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- The Financial Sector Assessment Programme (FSAP) is a joint IMF and World Bank initiative to assess the quality of countries' financial sector policies, including adherence to international standards, and to identify potential financial sector vulnerabilities. The FSAP was introduced as a pilot programme in 1999 and appears likely to be entrenched as a significant ongoing feature of the IMF's surveillance arrangements. The IMF and World Bank plan to conduct FSAP assessments of all member countries at least once in the next five years.
  - The Reports on Observance of Standards and Codes process (ROSC) is also a joint IMF/World Bank initiative, involving periodic external assessment of a country's compliance with international standards and codes. It was introduced as a result of the work done by the G22 group of countries in 1998, when the G22 advocated greater transparency and assessment of compliance with standards. A number of ROSC assessments have been conducted to date and many more are planned in the future. The results are fed into IMF surveillance consultations and form part of the planning for technical assistance programmes, particularly for developing and emerging economies and OFCs.

In addition, a number of standard-setting bodies have conducted surveys of countries' regulatory frameworks using international standards and related assessment methodologies as the benchmarks for this assessment. In this context, New Zealand regulatory agencies have completed a number of surveys from various international bodies in recent years, including the IMF, Basel Committee on Banking Supervision, IOSCO and APEC. And in 1999, New Zealand was subject to a FATF evaluation of the measures that New Zealand has put in place to combat money laundering.

The IMF is also undertaking work on strengthening its own capacity, and the capacity of individual countries, to assess potential vulnerability in financial systems and in the broader economy. To that end, the IMF is refining its approach to stress-testing countries' financial systems, developing techniques for evaluating the effects that economic shocks can have on financial stability. It is also exploring the efficacy of using economic and financial indicators as a means of detecting impending financial system distress. In this context,

the IMF has surveyed member countries to assess the extent to which national authorities currently use indicators of their economy and financial sector as a means of assessing the state of the financial system and the country's risk of financial instability.

The strengthening of international surveillance and vulnerability analysis techniques has the potential to assist national authorities in identifying vulnerabilities in their economies and deficiencies in policies. However, as with the development of international standards, it is important to have realistic expectations of what surveillance programmes can achieve, particularly given resource constraints in the international agencies responsible for conducting surveillance and in the countries being assessed. And it is important that international surveillance is not conducted in a mechanistic manner.

If surveillance is to be useful, it needs to focus on an assessment of the substantive quality of a country's economic and financial policies, having regard to the particular circumstances of its economy and financial system, rather than on whether a country complies strictly with international standards. Surveillance programmes also need to be designed in ways that are sensitive to the priorities and needs of particular countries, focusing on the policy issues that matter most for each economy, rather than attempting to cover all policy issues regardless of their relevance to the country in question. In that regard, it is important to recognise that international surveillance programmes impose substantial compliance costs on countries, as does the process of implementing policy reforms.

There also needs to be a realistic approach to the development of macro-prudential indicators and early warning signals. Although such indicators have the potential to provide some insights into potential vulnerability and incipient financial distress, they need to be interpreted with skill and caution. Recent decades have demonstrated that financial crises are complex – the causes and dynamics vary in each case. No single set of indicators can provide a reliable means of assessing potential vulnerability to crisis.

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## Private sector involvement in debt defaults

As indicated earlier in this paper, there has been concern that IMF funding packages have enabled some private sector creditors to be bailed out by official rescues, thereby reducing market disciplines on both lenders and borrowers and weakening the incentives for prudent risk management and the adoption of sound economic policies. This has led to the exploration of options for more effectively involving private creditors in the process of resolving debt default situations. A wide range of options are being considered, including:

- modifying the terms of international sovereign bond contracts, so that creditors have a greater opportunity and incentive to reach a settlement agreement with the debtor, rather than having incentives to be the first to run in the face of a country experiencing financial difficulty;
- eliminating the regulatory bias to short-term inter-bank credit lines, including by assigning higher capital risk weights to banks' short-term debt claims;
- encouraging debtor countries to put in place private contingent credit lines, so that liquidity support is available in periods of financial difficulty;
- encouraging the use of creditor committees and improving insolvency law to provide greater scope for involving creditors in the resolution process in debtor default situations; and
- the possible use of debt standstills in a period of financial crisis. A debt standstill would be designed to freeze temporarily the repayment of debt in order to stem the extent of capital outflows, ease pressure on the domestic economy and provide time for the implementation of a programme to resolve the crisis. Consideration is being given to the feasibility and efficacy of standstills on sovereign and private debt, including:
  - moral suasion by authorities in the creditor countries, designed to encourage creditors to defer taking action under debt contracts and to leave their funds in the debtor country until a package of solutions has been put in place;

- suspension of sovereign debt repayments in the debtor country;
- the use of insolvency frameworks to suspend private debt obligations; and
- the imposition of exchange controls or capital controls.

Although considerable effort has been expended in exploring these options, the issues are complex and it seems unlikely that concrete solutions will be implemented in the near future.

## Cross-border capital flows

As a result of concerns over the potential for cross-border capital flows at times to contribute to financial and economic instability, the FSF (among others) has undertaken work in assessing the risks associated with capital flows and the policy responses required to reduce these risks. A report was released by the FSF earlier this year and, like other reports on this subject, it concluded that the risks associated with cross-border capital flows are outweighed by the benefits, provided that appropriate risk management frameworks are in place. It recommended (among other matters):

- the implementation of policies to strengthen financial markets, including effective banking supervision, corporate governance and disclosure requirements;
- the development of vulnerability indicators - including stress testing - as part of the tool box for assessing and responding to potential financial system distress before it becomes a crisis;
- improved structures to manage the risks associated with offshore borrowing, in both the public and private sectors;
- measures to reduce the regulatory bias to short-term capital flows (such as the lower risk weights currently assigned to short-term debt claims in the international capital ratio requirements for banks);
- strengthened supervision of foreign currency exposure positions of financial institutions and other systemically important corporate entities;

- the provision of technical assistance to developing and emerging economies to enable them to strengthen their capacity to manage risks associated with cross-border capital flows (including in the areas of liquidity risk, interest rate risk, currency risk and in the management of public debt); and
- the implementation of measures to develop deeper and more diversified capital markets at a national level so as to reduce reliance on funding from banks and strengthen the capacity to manage financial risks.

There has also been considerable international discussion of the efficacy of capital controls as a means of managing the risks associated with cross-border capital flows. There is a wide range of views on this issue, with some countries (and other commentators) arguing that capital controls can assist in reducing some of the risks associated with capital flows, particularly in terms of reducing the bias towards short-term debt funding. And some commentators argue that capital controls may assist in stemming capital outflows in a crisis, enabling other (longer-term) measures to be implemented. However, there is also a recognition that capital controls impose costs and distortions on an economy, are prone to evasion (and therefore may become less effective through time), and are not a substitute for fundamental policy reform. Reflecting this latter view, most of the international reform effort has been directed at tackling the underlying risks associated with capital flows, rather than placing reliance on capital controls as a solution.

Another issue that has emerged in the international discussions on cross-border capital flows is the importance of the choice of exchange rate regime. As discussed earlier in this report, some economies with pegged exchange rates have experienced considerable financial instability where large outflows of capital have forced the abandonment of the exchange rate peg. The large currency devaluations that followed the abandonment of the peg exposed financial institutions and corporates to substantial currency losses on their unhedged borrowing. This, in combination with the increase in interest rates and decline in asset prices associated with sharp falls in the exchange rate, created severe financial instability in some countries.

In recognition of the difficulties associated with “soft” exchange rate pegs or actively managed currency floats, there appears to be an emerging consensus in some quarters that the risks associated with cross-border capital flows could be lessened by the adoption of either a strongly anchored peg (such as a currency board arrangement) or a largely market-determined exchange rate. In-between currency arrangements, such as soft pegs and tightly managed floats, are seen to be of higher risk, not least in terms of the reduced incentives they create for currency hedging and the somewhat greater risk of being subject to currency attack. However, it is also widely recognised that the choice of exchange rate regime is a complex matter and that the nature of the exchange rate arrangements will be influenced by, and needs to complement, other policy arrangements and structural features of the economy, such as monetary policy and the nature of financial and factor markets. Ultimately, what matters most is that, regardless of the nature of the exchange rate arrangement, it is seen as sustainable and credible in the eyes of investors and other market participants.

### Offshore financial centres

As noted earlier, there have been concerns in relation to the role that some Offshore Financial Centres (OFCs) may play in facilitating money laundering, tax evasion and other illegal or unethical financial practices, and in encouraging distortions to capital flows, with implications for broader financial stability. As a result of these concerns, the FSF released a paper earlier this year identifying the OFCs that appear not to comply with key international standards and which may pose a risk to the integrity of the international financial system. As a result of the FSF’s work, and further analysis by the IMF, there are proposals to request OFCs to undergo comprehensive external assessments of their compliance with international standards, with a view to encouraging OFCs to implement core standards as soon as practicable. In addition, it is likely that supervisory authorities in the major financial centres will tighten restrictions on the ability of financial institutions in their jurisdictions to have dealings with entities based in OFCs that fail to comply with international standards. Consideration is also being given to strengthening incentives for OFCs to adhere to international standards.

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## Highly Leveraged Institutions (HLIs)

As a result of the concerns over HLIs referred to earlier in this article, a considerable amount of international attention has been given to assessing the policy issues posed by HLIs and evaluating the options for addressing these difficulties. Work on aspects of these issues has been undertaken by a number of agencies, including the FSF, IMF, Basel Committee on Banking Supervision and some national authorities.

There is a general consensus that HLIs (and other financial market participants) can at times have adverse impacts on market dynamics in small and medium-sized economies. These impacts can include amplification of market pressures on exchange rate regimes and compromising market integrity. There is also general agreement that large HLIs have the potential to pose a threat to financial stability in the event that they become insolvent or are forced to deleverage rapidly. Instability can arise through the possibility that counterparties (such as banks) providing funding to HLIs may sustain substantial losses, and through the effect that the collapse or instability of HLIs could have on market liquidity, interest and exchange rates and the value of collateral.

Notwithstanding these risks, it is also important to acknowledge that speculative and related activities by HLIs and other market participants can be constructive, by promoting greater market depth and efficiency, with resultant benefits for the financial system as a whole. Moreover, HLIs can play a helpful role in introducing additional market disciplines on policy makers, by sharpening the incentives for governments to maintain sound and credible policy settings. In assessing what policy responses should be adopted in respect of HLIs, it is therefore important that a balanced approach is taken to the assessment of the costs and benefits associated with HLI activities.

A number of policy recommendations have emerged from the reports on HLIs, including:

- improving risk management by HLI counterparties, so as to reduce the risk of financial instability arising as a result of the collapse of systemically important HLIs;
- strengthening the supervision of HLI credit providers (and particularly systemically important banks whose business involves substantial provision of credit to HLIs);

- improving risk management practices within HLIs through strengthened corporate governance, internal controls and financial disclosure;
- strengthening the disclosure requirements applicable to HLIs;
- promoting mechanisms to reduce HLI risks, such as improved harmonisation of documentation and improved structures for managing and accessing collateral; and
- promoting more effective surveillance of financial markets by national authorities.

## 4 What implications do these reforms have for New Zealand?

Although many of the international financial reforms are directed at developing and emerging economies, and, in some cases are therefore of little direct relevance to New Zealand, some of the reforms do have implications for New Zealand (and for virtually all other countries). As an open economy, with substantial international trade linkages and an open capital account, New Zealand's economic prospects are closely tied to its ability to trade effectively and to access international capital markets. Therefore, New Zealand has a strong interest in encouraging the implementation of policies, at international and national levels, to promote sustainable economic growth and financial stability in the world economy. And New Zealand also has strong incentives to maintain sound and credible economic policies and a robust financial system in order to maintain investor confidence in the New Zealand economy.

In that regard, the Reserve Bank and other relevant government agencies are taking a close interest in the international reforms. Where appropriate, the Bank and other government agencies have sought to influence international thinking through participation in the IMF, APEC, the Commonwealth and other regional forums.

We have taken a particularly close interest in the development of international standards and codes, to assess the possible implications for New Zealand's policy framework, particularly

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in respect of such matters as banking supervision and securities market regulation. In most respects, New Zealand's economic and financial sector policies are in accord with the substance of key international standards – and in many areas go well beyond the principles set out in the standards. However, there are areas where our policy frameworks depart from international standards. In some cases, this reflects an intentional design of policy. In other cases, it may reflect a need (generally already recognised) for further policy reforms.

For example, in the area of banking supervision, New Zealand's policy framework departs from international standards in some key respects (such as the absence of on-site examinations of banks, a lower level of direct prudential regulation and the absence of deposit insurance). This generally reflects the fact that banking supervision policy in New Zealand has been designed to reinforce the role that market disciplines and banks' self-discipline can play in promoting a sound and efficient financial system. Our approach to banking supervision places prime emphasis on public disclosure and bank director accountability as key elements in promoting systemic stability, and departs from international practice by placing less emphasis on the direct regulation of banks and the private examination of banks. Notwithstanding these differences in approach, we are satisfied that the balance of policy is appropriate for New Zealand's financial system and is serving New Zealand's interests well, and that fully implementing international standards in this area could be undesirable and counter-productive.

Similarly, there are aspects of New Zealand's approach to securities market regulation that depart from international standards due to a conscious design of policy and where a rigid application of international standards would be inconsistent with New Zealand's policy objectives.

In some other areas, however, international standards may assist New Zealand to review and implement appropriate policy reforms. This suggests that standards need to be considered on a case by case basis to assess their relevance and appropriateness, having regard to our economic and financial policy objectives and our need to maintain international and domestic investor confidence. It is likely, therefore, that future policy reviews in New Zealand (as in most countries) will take into account the policy advice

implicit in international standards, and have regard to any analysis that might emerge from a future external assessment of New Zealand's economic and financial policies (such as that arising from IMF surveillance).

While in most respects, we are satisfied that New Zealand's policies - including in respect of risk management structures - are consistent with the thrust of policy conclusions contained in the FSF reports and other reports on cross-border capital flows, we are refining our approach to monitoring macro-prudential indicators. In the same vein, we are giving consideration to using stress testing techniques to assess further possible financial sector vulnerability to sharp reversals of capital flows.

The proposals for strengthening international surveillance of OFCs is also of interest to New Zealand. Although New Zealand itself is not an OFC, and is not directly affected by international proposals in respect of OFCs, it does have association with some Pacific Island states that are classified as OFCs. Accordingly, the New Zealand authorities are involved in considering possible initiatives to strengthen surveillance of affected Pacific Island countries and related matters, with a view to encouraging a constructive and realistic approach to the issue in the Pacific region.

## 5 Conclusion

The efforts currently under way to implement reforms to the international financial system are a positive development. They reflect a growing awareness of the benefits and risks associated with a global economy where, increasingly, national boundaries are becoming less and less relevant and where international capital can move from one country to another with the click of button. Such a world offers enormous opportunities for economic development and growth, by providing scope for a more efficient allocation of resources and greater ability to access the funds of international investors. But it is also a world with risks. Rapid financial and economic liberalisation can expose an economy to the risk of poor lending and investment decisions, with potentially severe consequences for economic growth and financial stability. Rapid liberalisation, insufficiently supported by measures to manage risks effectively, can also expose an economy to a higher risk of sudden capital outflows, with

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possible implications for financial instability and painful economic adjustment.

Even where a country has moved through the liberalisation process and has implemented measures to promote effective risk management, it still faces the possibility that an adverse shift in investor sentiment, however triggered, could have potentially serious consequences for the economy and stability of the financial system. Therefore, in a world of increasing capital mobility, there is a growing recognition of the need for countries to maintain sound and credible economic policies, robust transparency arrangements and a strong financial system. The measures currently being implemented at the international level could be expected to assist in this regard, by raising awareness and understanding of the relevant policy issues and by providing a framework for assisting desired policy reforms.

Notwithstanding the progress made to date, the IMF and other international agencies face a difficult task in trying to lessen the risk of future financial instability and to deal more effectively with financial crises once they break. In some cases, the ambitions in these processes have run well ahead of the capacity of the respective agencies and countries to deliver. The reforms now emerging reflect the art of the possible and, in most respects, represent relatively modest, incremental initiatives for application at a national level, rather than being reforms of the international financial “architecture” per se.

The Reserve Bank’s own input to these processes will continue to stress the following themes:

- A “one size fits all” approach is neither feasible nor desirable. Although international standards and codes provide a useful framework to assist national authorities in assessing, reviewing and implementing desired policy reforms, it is important to recognise that the nature of economic and financial policies will necessarily depend on the particular circumstances of each country. It is therefore important that standards and codes are not viewed as rigid policy templates, but as frameworks to assist in the design of policy.
- Although the development of international standards and codes is an important element in the promotion of desired policy initiatives, there is a need for a prioritisation

of standards and a recognition that the policy priorities will vary from country to country. There is also a need for more targeted technical assistance to enable developing and emerging economies to make substantive progress in implementing desired policy reforms.

- There is a need for careful coordination of initiatives, so as to minimise duplication of effort. With so many participants in the reform processes, some duplication of effort is inevitable (and not always unhelpful – different perspectives can give rise to a higher quality of debate and assist in promoting desired outcomes). But it is desirable for the reform process to be as well coordinated as possible, so as to minimise unnecessary duplication of effort and the pursuit of conflicting objectives.
- Strengthened external surveillance and vulnerability assessment have the potential to assist in identifying countries’ potential vulnerabilities to financial instability and provide guidance in the design and implementation of desired policy reforms. However, it is important to ensure that external assessment focuses on evaluating the substantive quality of policy, having regard to the particular structure and circumstances of the economy in question, and avoids a mechanistic approach to the assessment of compliance with standards.
- The development of macro-prudential indicators and other early warning signals needs to take into account the limitations of what these structures can achieve. While some use of stress testing and early warning indicators has potential benefit, it is important to avoid a uniform template, and to recognise that these kinds of indicators need to be interpreted in the context of the particular structural features and circumstances of a country’s economy and financial system.
- Although reforms to the international financial system are important, in many respects the hardest work, and the real gains, lie in incremental reforms at a domestic level. In this respect, the term “global financial architecture” is a misnomer, given that most of the policy reforms required are in respect of domestic financial systems and national economic policies. Future progress will therefore require continued commitment by national

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authorities to implement the desired economic and financial policies, having regard to the particular circumstances of each country.

- Finally, it needs to be recognised that there is no “silver bullet”. No reforms will eliminate the risk of future financial instability, and it would be unwise to try, given that there is inherently some degree of trade-off between

economic growth and risk. All that can be realistically achieved is the implementation of policies and structures to reduce the risk that periodic episodes of financial distress do not evolve into major crises, and to have in place a framework (at national and international levels) to facilitate the speedy and effective resolution of financial instability.