Comment on "Lessons from the Recent Financial Crisis for Reforming National and International Financial Systems: The Road Ahead to a Sustainable Global Economic System," by Stijn Claessens

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Stijn Claessens's paper offers a comprehensive review of the causes of the current financial crisis in comparison with past crises and makes many sensible recommendations regarding the national and international financial architecture. It is, without a doubt, an excellent paper.

His paper concludes, "The financial crisis has brought a number of weaknesses in economic policy and national and international financial architecture into the open. The reform agenda is large, much remains to be done, and new questions have come up for the design of national and international financial systems." I could not agree more.

In that connection, let me focus on three issues, which in my view could have been explored further in Claessens's paper. Those are institutional aspects of national financial architecture, the international monetary system, and global imbalances.

National Financial Architecture

An important question to ask is, what lessons can we draw from the current crisis? There is a danger that emerging markets and developing countries may learn the wrong lessons from the current crisis. What appear to be the "right" lessons for advanced markets may not always be the right ones for developing countries. For the advanced markets, for example, stronger or expanded supervision of those outside of regulatory oversight and reregulation may be the right lessons. However, for many emerging markets and developing countries, the opposite—that is, enhanced deregulation of their financial system—appears to be the key to the problems they face today. Many structured products and derivatives, of which opaqueness and complexity contributed to the buildup of systemic risk in the advanced markets,

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have not been widely introduced in most emerging markets. The emerging markets' direct exposure to these products has been very small. The problems in emerging financial markets are still too much regulation, too much control, and too many interventions by the government, stifling innovation and efficiency improvement in the financial sector. The current crisis should not give reasons for the governments or politicians to overreact by further strengthening government control and interventions. In most emerging markets, it is not too little regulation that has to be addressed, but too much of it. As the title of Gary Gorton's recent paper, "Slapped in the Face by the Invisible Hand" (Gorton 2009) suggests, too much reliance on the invisible hand may be guarded at all times in advanced economies. However, in developing economies and emerging markets, the invisible hand is still tied behind the back or has not become strong enough to slap the face of the market. If the lessons learned from the crisis push developing countries to move toward stronger regulation, I fear that the future innovations and development of their financial systems will face greater challenges.

Having said that, I believe that the current crisis raises questions common to both advanced and emerging economies in relation to the shape of the financial industry. Those are, first, would it be wise to encourage, through the regulatory framework, the emergence of mega banks and financial conglomerates? And, second, how can we strengthen systemic regulation and macroprudential regulation?

Regarding the first question, many emerging markets have followed the trend of regulatory reforms in the international money centers during the last decade or two. Now they may have to rethink their policies promoting mega banks, financial conglomeration, and a universal banking system. As Claessens discusses in his paper, one of the causes of the current crisis is the increased interconnectedness among financial institutions and markets. In the current financial market environment, it is true that the banks and other financial institutions have to be big enough to compete in international markets. In order for banks in emerging markets to be internationally competitive, they have to be much bigger relative to the size of their economy than banks in advanced economies. Considering the systemic importance that these mega banks will have, the government is likely to become the captive of these large banks and financial conglomerates. If all banks become too big to fail and government cannot let them exit from the market even in the case of mismanagement, then this is no longer a sound market economy. Economies of scale and scope are important, but increased interconnectedness can increase the systemic threat of a mismanaged individual institution. The current crisis poses a question for both emerging and advanced markets regarding the architecture of the financial industry: to what extent should the government encourage the conglomeration of the financial industry and mergers among banks and non-bank financial institutions? There is an obvious trade-off between competitiveness of individual financial institutions or groups and long-term stability of the financial system as a whole.

Regarding the second question, it has become clear that the supervision of individual institutions would not have been sufficient to prevent the crisis. Systemic regulation is also required—that is, regulation that not only takes into account an indi-

vidual institution's risk but also its potential to form systemic risk. At the same time, the importance of macroprudential regulation must be highlighted. In that connection, the roles and responsibilities of the central bank (monetary authority), regulatory bodies, and finance ministry (financial sector policy or architecture) have to be reviewed carefully to confirm whether each of them has adequate power to deal effectively with a crisis. If necessary, their roles need to be redefined. The recent U.S. proposal to strengthen the role and responsibility of the Federal Reserve Board will provide momentum for many other countries to rethink the role of their own institutions. Given its responsibility to provide liquidity support in times of trouble, the central bank needs to have firsthand information on the status of financial institutions that could pose a systemic risk.

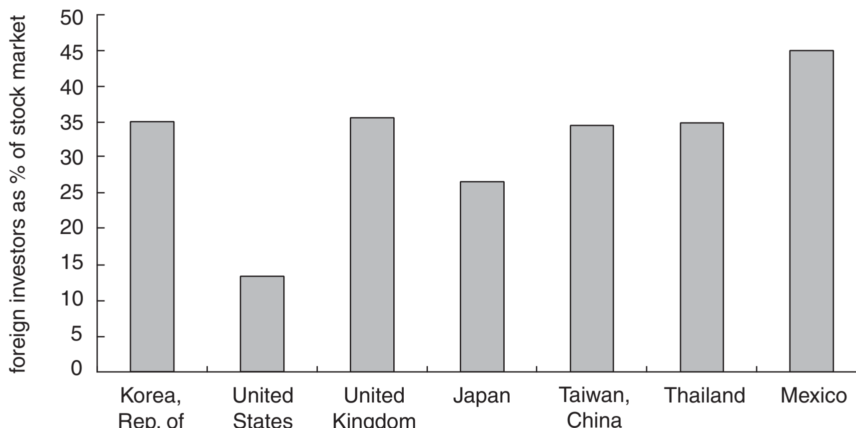
International Financial Architecture

In his paper, Claessens says that "international financial architecture is still far from institutionally matching the closely integrated financial systems." I absolutely agree. This is one of the fundamental causes of the current global financial crisis. The global financial market has been integrated like a single market, but there is no single authority or institution that governs the supply of liquidity and oversees the global financial market. This asymmetry poses great challenges.

Let me focus mainly on the problems faced by emerging and developing economies in this regard. Most emerging-market currencies are not convertible. With global financial integration comes an increasing proportion of the assets and liabilities of banks and non-bank financial institutions that is denominated in international settlement currency, especially the U.S. dollar. This leaves national governments and central banks in a helpless position when facing a dollar liquidity problem. For example, during the period of deleveraging in the United States and Europe, emerging-market financial institutions faced severely constrained liquidity. The central banks of international settlement (or reserve) currency, including the U.S. Federal Reserve Board, the European Central Bank, and the Bank of England, provided liquidity to their domestic institutions, but they did not, and could not, do the same to foreign institutions, despite the fact that both domestic and foreign institutions made transactions in the same currency. This deepened the instability of the exchange and financial markets of emerging-market economies. The balance sheet effect of exchange rate volatility further deepened the crisis in these economies.

As Claessens says in his paper, many emerging economies have a short history of financial market opening, but they are increasingly more integrated into international financial markets. Advanced countries have gradually opened their financial markets during the last 50–60 years, whereas most emerging-market economies only began to open in the 1990s. However, with regard to the size of assets and capital flows relative to the size of the economy, many emerging-market economies are more integrated with the international markets than advanced economies (see figure 1).

FIGURE 1.
Share of Foreign Investors in the Stock Market in Select Economies, 2006



Source: Korea Financial Supervisory Service.

Regarding the share of foreign banks in the banking industry or foreign investors in domestic stock markets, emerging markets are more heavily exposed to international transactions than advanced markets. Yet their institutions and systems have not been established to an extent that will allow them to weather the problems associated with high exposure to international capital flows. The root of this challenge goes back to the nonconvertible nature of their currencies. As such, emerging-market economies are more vulnerable to the contamination and spillovers of crises originating elsewhere.

Countries have two options to consider in this case. First, they can reverse the process of integration or at least reduce the pace of integration. Second, they can build up a strong safety net against a crisis induced by increased integration. In fact, the second option might be the only practical one, since they would find it difficult to give up the advantages generated by greater integration. What would such a safety net entail?

1. Accumulation of large amounts of foreign reserves
2. Readily available foreign liquidity support by international financial institutions such as the International Monetary Fund
3. Liquidity support by central banks of reserve currency countries

With regard to the first option—the accumulation of foreign reserves—before the current crisis, concerns had been expressed regarding the buildup of large foreign reserves, mainly because large reserves were seen as too costly and too distortionary for the exchange rate. If, however, the Republic of Korea had not accumulated such a large amount of reserves, it might have become the victim of another currency crisis. The costly process of building up reserves paid off to a large extent. Korea had foreign reserves amounting to $270 billion, ranking fifth or sixth largest in the world, and yet Korean authorities were not able to assuage anxious foreign investors and lenders. If every emerging economy would try to hold such large amounts of foreign reserves as insurance against crisis, the consequences would be damaging, including

mercantilistic domestic policies, undervaluation of the currency, promotion of exports, and continuation of global imbalances.

Regarding the option of foreign liquidity support, International Monetary Fund resources were too small, too slow, and too costly (in terms of policy conditionality) to be reliable. Korea again regarded such support as the last option, given its experience during the 1997 crisis.

In my view, the third option—liquidity support by central banks of reserve currencies—has to be explored further. A global central bank is not going to be established any time soon, so the role of the central bank of reserve currency countries has to be extended beyond the national border. According to recent Korean experience, a swap arrangement with the Federal Reserve Board is the most effective way to stabilize the exchange market. Even such a large amount of foreign reserves failed to quiet the worries and rumors of a shortage of dollars. The swap arrangement between the Federal Reserve Board and the Bank of Korea, however, was quite successful. A global central bank would be the first-best solution. But extending the role of lender of last resort of the central banks of reserve currency countries beyond their national boundaries could be the second-best approach. According to Claessens, "The best system—a global financial regulator, matching the current, financially closely integrated world and well resourced in staff, powers, budget, and financial resources—is unlikely to materialize soon. Other options, each of which could achieve varying degrees of global financial stability, are a new charter for internationally active banks, greater harmonization of rules and practices, and enhanced coordination." I believe that the same suggestion could be applied to the monetary authority. Swap arrangements between the central bank of a reserve currency country and the central banks of non-reserve currency countries should be expanded and strengthened. Of course, moral hazard problems can arise, but they could be addressed through the Financial Stability Board or through the International Monetary Fund's surveillance.

A regional monetary arrangement is another option to consider. Swap arrangements among central banks in the region or a regional monetary fund could also help to protect participating countries from the risk of a currency crisis.

International Standards and Rule Making

Again, I agree with Claessens on the role of developing countries in international rule making. Many of the international standards currently in place have a bias toward the circumstances of advanced countries. The question remains whether it is legitimate and also relevant to apply those standards to every country in the world. For instance, the currencies of developing countries are not international settlement currencies. Thus a large part of the transactions of their companies and banks is denominated in international currencies. According to current global accounting standards, the books of firms and banks in developing countries have to reflect the current exchange rate. When the exchange market becomes unstable, the debt ratio, capital adequacy ratio, and other financial indicators of firms and banks in these economies

become volatile. This, in turn, can magnify the instability of the financial market and the real economy.

To date, developing countries' participation in global forums such as the Financial Stability Forum, the Basel Committee on Banking Supervision, and other groups has been limited. The representation of developing countries and emerging markets in these groups will have to be enhanced. I fully support Claessens's argument that some overrepresentation in standard-setting bodies and tilting of the bargaining position toward developing countries would be helpful.

Global Imbalance

Claessens's paper does not address the issue of global imbalances at all. As many economists agree, the current crisis has much to do with long-sustained global imbalances. Unless we tackle this issue, the discussion of the sustainable global economic system cannot be complete. The key issue here is to share responsibilities among major economies. The most important economies in the global economy are the United States, Europe, and China. Among these three, the Chinese currency is not yet convertible.

The savings and investment gap between the United States and China has to be addressed. In this regard, China will have to expand its domestic consumption and corporate investments through reforms in pension, housing, health care, capital markets, and corporate governance. At the same time, the renminbi should be made convertible and allowed to float more freely in the market. The exchange control and capital market restrictions should be reduced. This would lead to more proper valuation of the Chinese currency and to the rebalancing of current account positions among these countries. Ultimately, the big discrepancy in the exchange rate regime among major economies will have to be addressed if we are to correct the global imbalances and achieve sustainable global economic growth.

Reference

Gorton, Gary. 2009. "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007." Paper prepared for the 2009 financial markets conference "Financial Innovation and Crisis," Federal Reserve Bank of Atlanta, Atlanta, GA, May 11–13.