WHAT DOES THE HALIFAX COMMUNIQUE IMPLY FOR THE INTERNATIONAL FINANCIAL SYSTEM?

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Summary

The Halifax G7 Summit covered several pressing issues facing the world economy. The purpose of this lecture is to discuss the implications of the summit for the international economy. The lecture first briefly reviews how the G7 plan to deal with the issue of currency turbulence and international policy coordination. It then discusses at much greater length directions for the reform of the international financial institutions, mainly the IMF and the World Bank, in the wake of the recent financial crisis in Mexico. To prevent future crises the G7 emphasize the role of information, including better provision of data by countries, and enhanced surveillance by the IMF. An increase in financial resources for the IMF is also necessary to deal with future crises. The lecture ends with the policy implications of the Mexican crisis for Korea.

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I. Introduction

I will talk today about some aspects of the Halifax communique of June this year, and what it is likely to mean for the international economy. The fifty paragraph long communique touches on many issues, including the Russian and Ukrainian economic reform programs, the reform of the international financial institutions, the possibility of a development bank for the Middle East, and currency turbulence.

I will focus on two topics discussed at Halifax: First, what does the communique say about currency turbulence and international policy coordination? Second, what does it say about the reform of the international financial institutions, primarily the IMF and the World Bank, and particularly in the aftermath of the Mexican turbulence?

II. Currency turbulence and policy coordination

The communique says very little on currency turbulence beyond endorsing the conclusions reached in April by G7 ministers in Washington. The G7 promise to redouble their efforts to deal with currency turbulence and say that it should be watched. The background document says that the most effective way of reducing currency turbulence is to ensure that each country keeps its own economy in good shape, but that coordinated intervention can also be useful in moderating currency movements when exchange rates get out of line with fundamentals.

There is no hint of target zones for currencies. It is absolutely clear that the G7 intend to do nothing in their domestic economies solely for the sake of its international impact. So we are quite far away from serious international policy coordination in order to stabilize exchange rates. We in the IMF have been told by several of our important members that, "If you urge us to do something for the sake of international coordination, it makes it more difficult to do from the domestic political view point. Please don't ask us to do anything because it's good for the exchange rate or good for other countries. If we then respond, we'll be criticized domestically." The Halifax communique gives no reason to think that such positions have changed.1/

III. Reform of the international financial institutions

III. 1. Changes in the IMF and the World Bank

The second aspect on which I will talk, and at much greater length, is the reform of the Bretton Woods institutions. When the G7 last met, one year ago at Naples, they decided that the Halifax summit, to be held during the fiftieth anniversary year of Bretton Woods, would be devoted in part to

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1/ (September 1995) I have not changed the text to reflect lessons of the coordinated intervention by the Bank of Japan, the Fed, and the Bundesbank in mid-August to drive the dollar up and the yen and deutschmark down. The central banks appear to have moved the markets significantly without changing domestic policies, except insofar as Japan liberalized portfolio regulations on capital outflows. Policymakers have emphasized that they intervened because they believed exchange rates were fundamentally misaligned; they also intervened in the same direction as the market was already moving. It is early to tell whether this success will lead to more frequent interventions. Most likely, such interventions will remain extremely infrequent.

considering the reform of the international financial system, particularly, the international financial institutions.

It seems obvious that some reform of these institutions would be necessary after fifty years. However, the notion that reform is needed because the Bretton Woods twins are fifty is based on a misapprehension. These agencies have been changing and evolving so much, that they certainly are not the institutions of fifty years ago.

Consider first some of the changes in the World Bank since Bretton Woods. The Bank has added IDA--the International Development Association, its concessional loan window, and the IFC--the International Finance Corporation, its private sector arm. They have also added MIGA, a loan guarantee facility against political risk. They have moved into adjustment lending, they have moved into lending to preserve the environment, into lending for education, and so on. These are all post Bretton Woods developments, and they make the institution very different from that set up fifty years ago.

The original role of the IMF was to monitor the fixed exchange rate system. This par value system collapsed in 1973. The main tasks of the IMF are now surveillance, lending, and technical assistance. Surveillance means reporting on individual economies and discussing them within the IMF Board and therefore with member governments. The Fund lends to a huge variety of mainly developing countries and has been operating very heavily indeed in the last few years in the transition economies of Eastern Europe and the former Soviet Union. We have lent sometimes to India and have an active dialogue with China. We provide a great deal of technical assistance to many countries including some who do not borrow from us.

The agencies are very different for those which fifty years ago opened with 44 members. Each now has 179 members. We are discussing the entry of our 180th member, Brunei--Darussalam, which is not likely to be a candidate for borrowing. Both the World Bank and IMF have moved from being small organizations dealing largely with Latin America and the industrialized countries plus a few countries in Asia and Africa, to become truly universal agencies.

III. 2. The Mexican Crisis

Nonetheless, the agencies have room for reform. The Halifax document refers to several of those reforms in particular as they relate to the aftermath of the Mexican crisis. The G7 had been thinking about these issues before Mexico, but the Mexican crisis gave focus to their considerations of how to reform the international agencies.

If any of you were at the Madrid meetings of the IMF and the World Bank in October 1994, the 50th anniversary meetings, you might recall that at the conference, everybody said, "This world is very different from the world of 50 years ago because of the globalization of capital markets." However, it was not at all clear what implications this fact had for the role of either the IMF or the World Bank.

The Articles of Agreement of the IMF require the Fund to promote current account liberalization, but capital account restrictions are permitted. There is no hint in the IMF Articles of Agreement that private sector international capital flows would become an important factor again, as they were before the first world war. The Fund does not have jurisdiction over the capital account; people at Bretton Woods did not think it would be an issue.

After Madrid came Mexico. What happened in Mexico was the typical crisis of an overvalued currency, something which in normal times, 20 years ago, would have led to a devaluation -- nothing very spectacular, just an ordinary sort of adjustment. What happened in Mexico this time -- because of the scale of international capital flows -- was that within a period of two and a half days, capital markets turned from being willing to lend to Mexico at an annual rate of about 25 billion dollars, 8 percent of GDP, to wanting to take out not only that 25 billion dollars but also another 60 or 70 billion dollars previously invested in Mexico.

Mexico, which needed to make a big current account adjustment of about 20 or 25 billion dollars, would have had to make a much bigger adjustment to deal with the capital outflows. That was the difference. It was frightening to see what a switch in sentiment on that scale could do.

The Mexican situation was stabilized when the United States and the IMF put together a financial package of nearly 40 billion dollars. The United States and the IMF lent Mexico 20 and 18 billion dollars respectively, in a dramatic and controversial operation. We normally lend a maximum of 100 percent of quota to a country per annum, with a limit on total lending of 300 percent. In the case of Mexico, 100 percent of quota is 2.5 billion dollars. We committed to lending Mexico 7 times as much as the normal maximum. This is nearly four times bigger than any loan we have ever made to any country, including the industrialized countries in the 1970s. Furthermore, the loan decision was made in the space of about 6 hours and against considerable opposition from some of the European countries who had the view that if Mexico was in trouble, it was up to the United States to fix it.

III. 3. Directions of reform

One question that this operation raised is, "How does the international community deal with future crises that may require financial resources on a scale far bigger than we have been used to so far?". The answer, which the international community has been developing and which is in the Halifax communique, is that we have to do better at preventing crises, and then--if they do happen--we have to have more resources and possibly new methods to deal with them.

I will talk about these three aspects in turn: first, doing better at preventing crises; second, raising more resources for dealing with crises; and third, perhaps developing new methods of dealing with future crises. Crisis prevention: The international community is very strongly emphasizing the role of improved information as a way to prevent crises and to make capital markets work better.

There are two types of information. One is statistical information that the international community wants every country to put out to enable the capital markets to monitor what is happening in that country. In the Mexican case, there was very little up-to-date information on the state of their international reserves and on the structure of their external liabilities. The international community is pressing the IMF to develop a list of standard indicators and to encourage countries to publish them. We have in fact developed a list of 16 key numbers that we want each country to publish and update frequently. We have no authority to compel this publication and it is simply a matter for a country to decide whether it publishes or not. There is also some pressure for us to publish information on how up-to-date each country's information is, in order to encourage them to meet the standards.

There are some objections among some of our member countries to our publishing such information on countries' statistical performance. I believe that most countries will eventually realize that there are benefits to them individually from such an approach. There may be a few countries where secrecy is part of the way of doing business, and that will remain reluctant to publish, but I expect that they too will go public in time.

The second type of information is the IMF's Article IV consultation report on each country's economy every year. This is a document prepared after a great deal of discussion with the member country, and then discussed by the Board of the IMF, which includes representatives of virtually all countries. We are being urged to make the reports on the Article IV consultation more hard hitting, more frank, less diplomatic and so forth. Well, we certainly can and will be more frank in these reports, but my clear impression is that every country wants us to be frank about every other country, but not about itself. The management of the Fund believes firmly in describing the situation as it is, and we are developing the capacity and the will to do that and to be much more open with the IMF Board in these consultations.

However, there is a problem. The Article IV consultation is a secret document that does not go beyond the governments of our member countries. It leaks very rarely. Some countries want to publish their own Article IVs. The huge majority however does not want its Article IV report published, and nor do they want others to be allowed to publish. They argue that if some countries publish, others will be forced to follow suit. I doubt that.

I do believe that countries where the IMF has an impact on policy through very frank and open discussions might be justified in not publishing their Article IV report. For instance, there are some countries--even some that do not borrow from us--that consult with the IMF in the formulation of their budgets. They trust us and involve us very closely in what they do. If such countries do not want to publish, that is fine. There are other countries, like the United States, where important aspects of policy are made completely in the open. The outcome of U.S. fiscal policy is not a result of a quiet decision within the administration, but rather the result of a lengthy process of very public discussion. The Fund is very unlikely to have any effect on U.S. fiscal policy unless its advice is made public. In terms of affecting U.S. policy, it would be better if the U.S. were allowed to publish its Article IV report, as it wants to. But the Board is not at present in favor of such an approach.

Under current circumstances, we exercise surveillance by informing countries of our views about their policies, and we also inform other governments, through the Board of the Fund. We do not generally make our advice immediately public. Now, it must be conceded that there are problems in going public. For example, the IMF could not announce that a certain currency was overvalued if there was active trading of that currency. We would always have difficulty making all our views known to the markets.

What this means is that there is a gap between what the G7 want us to do, which is to be hard hitting and frank, and what we can tell the markets. To prevent crises we can tell policymakers in that country that trouble is brewing, and we can also tell other governments. We can visit the country to make our views known to the authorities. But we cannot go further than that. For instance, in 1992 and 1993 when the European crisis developed, the IMF warned some countries of the trouble towards which they were heading. But they did not do anything about it, and the crisis came.

That is why better surveillance will not stop all crises. It should prevent some crises, and that would certainly justify the resources spent on better surveillance. But we will still have crises, both because governments ignore what they are told and because the IMF makes mistakes. We predict crises that do not happen--and not only because they are self-denying prophecies, and we will certainly miss some crises that will happen.

However it is not true that Mexico was an unforeseen crisis. It is a matter of record that the United States Treasury expressed strong concerns to Mexico at various points in 1994. This was the case of a government that ignored advice and got into trouble, not a case where the international community was unaware of what might happen; and this is therefore a case that establishes that better surveillance will not make crises disappear.

Resources: How then will we deal with future crises? Obviously, the international system will need access to financing to help countries adjust to future crises. In the case of Mexico, the United States was able, with a great deal of difficulty, to put up a lot of money. There are very few countries anywhere for which other countries or the United States would be willing to lend 10 or 20 billion dollars.

There is less and less willingness by individual countries to make international loans, except within the context of the European Union--and that means that if loans are needed to deal with future crises, they will have to come in some way from the IMF. For that purpose, the IMF will need more resources.

At present the IMF has a quota base of about 240 billion dollars. That is the amount of reserves that countries hold within the IMF. There is an old line about the IMF and the World Bank, which is that the Fund is a bank and the Bank is a fund. The Fund is a bank because member countries deposit reserves and money with the Fund and the Fund lends them out, just like a bank. However, not all the deposits in the Fund are usable for making loans, because borrowers do not want to borrow some of the currencies held by the Fund. In addition, some of the deposits have been used for making loans already. At present the Fund has a maximum of about 70 billion dollars available for lending. Our typical lending in a given year is somewhere between 15 and 20 billion dollars. So, we have enough resources to cover our normal lending for a few more years, but we do not have sufficient resources at present to deal with several Mexican-size crises.

What methods are there to provide more resources to the Fund? One possibility for the international community is to expand the GAB, the General Arrangements to Borrow, which is an arrangement in which the G10 plus Switzerland and Saudi Arabia stand willing to lend money to the IMF to make loans to countries in need. Currently, the GAB is 26 billion dollars.

The G7 communique says that GAB should be doubled, so that we should eventually have access to more than 50 billion dollars through the GAB.

However, it has not yet been decided how to expand the GAB. There are two basic proposals. One is for the current members, to double their contributions; the other is to expand the membership and to bring into the GAB the rapidly growing countries of Asia, among them of course Korea. This question is still being discussed by the G10.

The other way to provide more resources to the Fund is to increase the quotas of member countries. The management of the Fund is proposing a doubling of quotas. This is not as huge an increase as it sounds. We would have to increase quotas by 70 percent to maintain the size of the Fund (relative to world trade) at the level established at the last quota review. Then in light of currency turbulence and the rapid development of international capital markets, we are asking for another 30 percent. The G7 communique asks us to start work on increasing quotas now. It will take two to three years before it is clear whether and how large a quota increase there will be, for each parliament has to approve an increase in the country's quota.

The IMF also owns a large amount of gold, worth about 40 billion dollars. It is a hidden reserve which does not show up at that value on the balance sheet. We are being encouraged by some of our member countries to use some of this gold to help the poorest countries. The management has proposed selling a small proportion of the gold, worth 3 to 4 billion dollars, to help subsidize interest payments for the very low income countries.

The communique also asks the Fund to study the role of the SDR in the international system, as a potential way of creating assets. There have been major divisions over a potential issue of SDRs, but that possibility is still alive, and we will study it further.

Orderly workouts: The third approach to dealing with future crises has been vigorously advocated by Jeffrey Sachs, that there is a need for an international bankruptcy procedure. When a company cannot pay its creditors, it has the possibility of appealing to a court for a stay on payments, and a financial reorganization. Sachs argues that there should be a similar procedure for countries in trouble, that some international authority should be able to permit the country to stay payments and then develop a financing plan for the country, in conjunction with its creditors. For instance, in the Mexican case, the IMF rather than lending money to Mexico would have had the right to say that Mexico did not have to pay its creditors over the course of the next six months, or a year. During that time a detailed repayment schedule would be worked out. This is an interesting possibility, but one that would be very difficult indeed to implement--formidable legal difficulties stand in the way.

One of the main difficulties is that there are no procedures for bankruptcy of governments. There is provision for bankruptcies of municipalities in the United States, but not for state governments and certainly not of the federal government. Part of the problem is that the question of whether a government can make its payments or not is a political one. Could Mexico have paid its creditors in 1994 and 1995 without foreign assistance? Yes, if they had been willing and able to create a big enough recession in Mexico.

The second problem is to decide what payments may be stopped. It seems obvious that the bankruptcy court should have the right to stop payments to foreigners. However, if that were the case, you could be sure that next time everybody who lends to Mexico will lend through a domestic financial institution.

Despite these difficulties, I believe the idea of developing an orderly debt workout procedure is worth further consideration. No doubt it will take many years until something practical emerges, but it is worth trying.

These are the ideas for the reform of the IMF that came out of the Halifax communique. The G7 had a harder time making suggestions for the reform of the other international agencies.

At present an international task force is examining all the development banks, the Asian, European, Inter-American, African and World Banks, and will make suggestions for their reform. Their report is due next year, and the G7 will wait for their recommendations.

Thus the Halifax communique does not make radical suggestions for the reform of the international financial system. It makes very useful suggestions on the role of the IMF. However, it does not make proposals for dealing with currency instability, and has very little to say about the World Bank. The main reason there are no radical suggestions for reforming the system is that it has been reforming gradually over many years.

IV. Implications of the Mexican crisis for Korea

Before concluding and taking questions, let me say why I believe that Mexico has very few implications for Korea. In the first instance, as many people thought before the Mexican crisis, the Mexicans were running unsustainable policies. The current account deficit was 7 percent of GDP in 1993 and 8 percent in 1994. The budget presented by the Mexican government at the end of 1994 implied a current account deficit of 9 percent of GDP for 1995. Korea had large current account deficits in the 1960s and 1970s but unlike Mexico, Korea was growing very fast. Mexico's problem was that an external deficit of 7 to 8 percent of GDP is not sustainable when the economy is not growing fast.

The second reason the Korean situation is different is that Mexico was relying heavily on a fixed exchange rate to deal with its inflation problem.

The exchange rate was the nominal anchor of Mexican macroeconomic policy. To be clear, I do believe in using an exchange rate anchor to bring down very high inflation rates; but the anchor--the nominal exchange rate--should be moved when its level becomes inappropriate. I do not believe that Korea will allow itself to get into a position where the exchange rate is overvalued.

Third, during 1994, the Mexicans financed themselves externally by borrowing through short-term dollar-linked liabilities, the famous tesobonos, the stock of which increased by 20 billion dollars in 1994. This meant that the Mexican government greatly increased the cost of a devaluation to itself.

Of course, Mexico has negative lessons for Korea. A country should not borrow in a foreign currency in such a way that it gets into severe trouble if it is forced to devalue. Nor should it engage in a great deal of short-term borrowing. Nor should it run very large current account deficits. In that sense every country has something to learn from the recent Mexican crisis. And the Mexican crisis certainly demonstrates the power of the international capital markets. Nonetheless, none of these problems is presently relevant to Korea.

QUESTION

I agree with your argument that the international financial system is unstable and that the role of the IMF needs to be enhanced. My question is how will it help in practice to stabilize the international financial system if we give the IMF more resources.

ANSWER

The increases in the resources are intended to help countries that get into trouble or that are heading for trouble as a result of shifts in capital flows. What we saw in Mexico was that the speed and scale with which capital can flow out can make it very difficult for a country to adjust to an abrupt change of views by the capital markets. We need more resources to help countries that have temporarily lost access to the capital markets, as Mexico did at the beginning of this year. We were sure that, provided Mexico undertook an adjustment program, it could successfully deal with its debts. But the markets would not provide the funds to make that possible, and the official sector had to do so instead.

There was another aspect of the Mexico crisis that was important with regard to the scale of resources needed. We were concerned in January this year that we might be looking at the beginning of a second debt crisis. There were very large capital outflows from several major countries in Latin America and from other developing countries, some in Asia. Following the prices in emerging markets, you could actually see the transmission of the shock from Mexico to other countries. On days that the Mexican market went down, the markets in Brazil and Argentina almost always went down too. If you plot the day by day movements of emerging stock markets or Brady bonds for these countries, you will see a remarkably strong correlation between them. So, our fear was that if Mexico was forced to default and to be unable to meet its payments, capital would then flow out of Brazil, Argentina and other countries, and create major adjustment difficulties for them. If we have larger resources, not only will we be able to help a country deal with its problems, we will also provide reassurance to the markets that other countries can rely on our help if needed, and in the appropriate context.

There is some opposition to giving the Fund more resources, for what are described as moral hazard reasons--the argument that if countries know the Fund can help them when they get into trouble, they will be more likely to take risks that land them in trouble. This is the same argument that says you should not install seat belts in cars because they encourage faster driving.

I do not think that the moral hazard argument is persuasive about the types of policies a government will pursue. I do not imagine that any government anywhere wants to be in the position which the Mexican government found itself in as a result of its disaster, of having to deal with the United States Congress and the IMF. It is not a picnic. The IMF does not lend money just like that. It requires corrective measures that countries find very unpleasant. So I do not imagine that merely because we have money, you are going to find a lot of governments lining up to get the money from us with the conditions that we normally impose.

The more serious aspect of moral hazard is that investors who know that the IMF is available to help countries in trouble will be less cautious than they would have been about where they put their money. This is a problem, and one that should be minimized to the greatest possible extent, but it does not say that the Fund should not lend to countries in trouble that are willing to implement appropriate adjustment programs.

QUESTION

What do you think the IMF can do in dealing with the growing trend of destabilizing forces in the international financial markets such as hedge funds as represented by George Soros, Michael Steinhart and others using financial derivatives? By the way I heard that MIT conferred upon him a honorary Ph.D in economics.

ANSWER

I do not know whether George Soros has a Ph.D from MIT. Nobody told me about it. He does have a degree from the London School of Economics and he does have interesting theories about how to make money; they are set out in his book "The Alchemy of Finance".

On the whole, hedge funds had a very bad year in 1994. Players in those firms have concluded that there is much less easy money to be made than there used to be. Thus I expect we will hear much less about hedge funds for the next few years at least. The most publicized winning bets made by the hedge funds were those against currencies, but it's quite possible they were helping the countries concerned by forcing them out of an unsustainable situation earlier than would otherwise have happened.

There's not much that can be done to deal with the hedge funds, even if it were desirable. There is of course the Tobin tax. James Tobin has suggested not only the tax, but also that the IMF could be the agency that collects the Tobin tax and then gives the money to the developing countries. That should sound good to someone at the Fund, but I do not think the Tobin tax would work. You would have to get every financial center to agree to impose the tax, but the incentive to offshore centers to charge less would be so strong that the most likely outcome is no transaction tax.

In addition, I am not sure that the Tobin tax would stabilize the market price. What it might do is to produce periods of stability punctuated by more instability than we now have. Suppose everybody thinks the market is going offtrack. All of the participants would stand there until they think they can cover the costs of the tax, and then they all jump in and push prices. Over a period of three months prices would probably vary at least as much as they would without the Tobin tax. No doubt though that there would be fewer financial transactions.