Comment on Eichengreen's Reforming the International Financial Architecture after Ten Years: The View from Emerging Markets

by

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GFA Reforms: Emerging Markets' Perspectives

- Title misleading, not "View from Emerging Markets", rather perspective from Emerging Markets crisis, although paper also deals a lot with current sub-prime crisis.
- For Emerging Market views, in 2001 I was involved with a group of eleven emerging markets financial experts, consisting mostly of former Ministers of Finance or former Central Bank Governors, to come up with a set of recommendations on GFA reforms from the perspective of the emerging markets. This group was led by Dr. Il Sakong, former Minister of Finance of South Korea. We also had the advice of a number of prominent economists and financial experts, such as Paul Volcker and Joseph Stiglitz.
- The report was published as the Emerging Markets Eminent Persons Group (EMEPG) Report on Rebuilding the International Financial Architecture. Institute for Global Economics, Seoul, South Korea, October, 2001.

GFA Reforms: Emerging Markets' Perspectives (2)

- One recommendation concerns the short-term maturity bias of the Basel Capital Accord provisioning requirement. This led to an explosion of short-term debt to emerging markets in the 1990's and was one fundamental reason for the crisis.
- The issue is not easy to deal with and the bias remains in Basel II. As stated clearly by BIS, "Both intuition and empirical evidence indicate that long-term credits are riskier than short-term credits. As a consequence, the capital requirement should increase with maturity." (BIS. An Explanatory Note on the Basel II IRB Risk Weight Functions. July 2005.)
- This is certainly correct from the micro perspective of a particular lender. However, the bias leads to systemic risks in emerging market economies arising from over dependence on short-term debt. The 1997/98 crisis showed the huge costs that can arise from this.
- And the problem has certainly not gone away.

Foreign Reserves and Short-term Debt

	Date	Reserves Billion US$	Sh.Term Debt
Indonesia	End.July-08	60.6	33.0**
Malaysia	End.Sept-08	109.7	26.8
Philippines	End.Sept-08	36.7	8.796***
Thailand	End.Sept-08	117.1	25.3*
South Korea	End.Sept-08	239.7	222.3***
* End August 2008		** End 2006	
*** End June 2008			

Source: Official Sources.

In addition, reserves has to back up other short-term contingent liabilities, such as foreign holdings of stocks and bonds, which can be liquidated and exchanged for foreign currencies any time.

GFA Reforms: Emerging Markets' Perspectives (3)

- Another area of recommendation was the regulation of highly leveraged institutions (HLI), including but not limited to hedge funds.
- The group recognized that the use of modern financial instruments such as derivatives can help develop emerging markets, however it worried that they can also be a destabilizing factor in times of economic stress, and the report urged G7 governments to adopt the proposals of the Financial Stability Forum for indirect regulatory measures to be applied to HLI, and also to regulate bank lending to HLI in order to reduce their ability to mount speculative attacks on emerging markets.
- This would of course be against the interests of Wall Street, and it's not surprising that nothing concrete was done.
- Now, with HLI being blamed for the sub-prime crisis, the situation is different so some real reforms may happen (?).
- Another area is regional financial cooperation (already discussed in earlier sessions).

Domestic Reforms and the Sub-prime Crisis

- Seeing the kinds of policies being introduced to deal with the sub-prime crisis in the West, observers from Emerging Markets that went through the crisis a decade ago cannot help but feel annoyed.
- A decade ago, we heard so much of “moral hazard” and “crony capitalism” that we got sick of the phrases.
- Bailout plans that would substantially ease the pain from the crisis were rejected because of so-called “moral hazard”.
- We were lectured about widespread cronyism in our economies and how we needed to improve governance and carry out reforms to approach the best practices of the advanced economies (although this became less credible with Enron and such likes).
- Today these phrases seem to have dropped out of the dictionary altogether. Bailout needs override any considerations of moral hazard, and crony capitalism can be explained away by numerous justifications, such as the need to take bad assets from banks (at high prices) etc.

Domestic Reforms and the Sub-prime Crisis (2)

- Conflicts of interests appear to be prevalent. The role of credit rating agencies is under scrutiny (again) as Eichengreen explained very well. How mortgage related CDO's can be rated AAA is hard to understand.
- To me, particularly troublesome is the relationship between the US Treasury and Wall Street.
- As a former Finance Minister, I am barred by Thai law from working in any capacity in the financial system for two years after I leave office. It's amazing that US Treasury Secretaries can move so quickly into high positions in Wall Street or other financial institutions.
- Robert Rubin was Co-Chairman of Goldman Sachs before becoming Treasury Secretary and became Director and Chairman of the Executive Committee of Citi Group shortly after he left the Treasury; Paul H. O'Neill joined Blackstone Group as special advisor and consultant shortly after leaving the Treasury; John Snow became Chairman of Cerberus Capital Management shortly after ending his term as Treasury Secretary; and Henry Paulson was Chairman and CEO of Goldman Sachs before becoming Treasury Secretary. It will be interesting to see where Paulson moves to a few months from now.

Domestic Reforms and the Sub-prime Crisis (3)

- Eichengreen raised a very important point about emerging markets reforms.
- After 1997/98 crisis, reform direction was to move toward best practices, i.e. the features in advanced economies.
- Invested a lot of time and efforts; for example in Thailand culminated in passage of many important new laws in 2007, such as BOT Act, SEC Act, Financial Institutions Act and Deposit Insurance Act.
- With sub-prime crisis showing up the fragilities of financial systems and regulatory regimes in the advanced economies, a lot of rethinking will be necessary about the desired characteristics of financial systems and regulatory regimes in emerging markets economies. For example, Deposit Insurance Act may be redundant as everyone is moving to full deposit guarantee, including those without real crisis symptoms appearing yet such as Malaysia and Singapore.
- <u>Not clear where should emerging markets reforms go from here</u>.

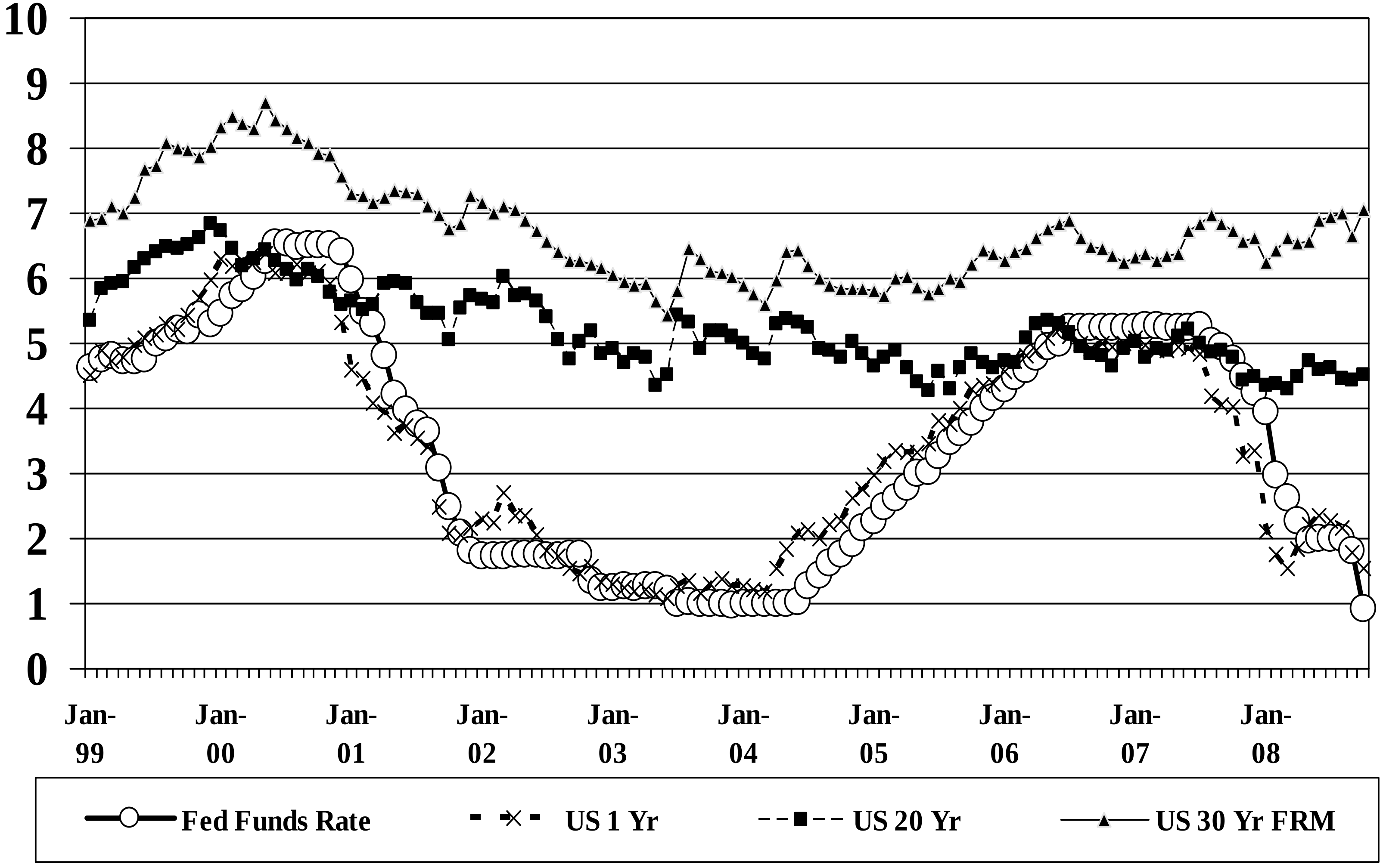
GFA Reforms: Involvement of Emerging Markets

- I agree completely with Eichengreen about the role of the emerging markets in the current sub-prime crisis. I agree that emerging market economies, particularly in East Asia, cannot deny some responsibility for the sub-prime problem.
- They have been relying on export as a major (or even main) impetus for growth over the past decade or so. In spite of large current account surpluses and rapidly accumulating foreign reserves, they have been very reluctant to let their currencies strengthen with respect to the US dollar in case it takes away their export competitiveness. This accentuates the global imbalance and provides the fuel for the bubble in the US.
- The major problem with the current GFA is that there is no rule-based gradual self-correcting mechanism within the system to prevent larger and larger imbalances from accumulating. There is of course a market based self correcting mechanism, and the sub-prime crisis can be viewed as a market correction to the global imbalance.
- However, market correction to imbalances normally involve huge disruptions, volatilities, over-shooting and painful adjustments.

GFA Reforms: Involvement of Emerging Markets (2)

- Exchange rate coordination among export competing economies is very difficult as was already discussed in earlier sessions. However, if the fall out from the sub-prime crisis becomes very severe, it may push countries in East Asia in that direction.
- Another avenue in which East Asian economies (here including also Japan) as well as other large saving surplus countries (such as the Middle East in recent years) relate to the crisis is through the interest rate channel.
- I have been writing and speaking for a number of years now that the US Federal Reserves no longer has the full ability to control monetary conditions in the US, particularly long-term interest rates.
- In recent years, there is a worrying disconnect between policy rates and long-term rates. While the Federal Reserve has been actively pushing up short-term rates between mid-2004 and mid-2006, long-term rates and mortgage rates hardly moved. During that time, it was becoming clear that the US real estate market was overheating. Significant increases in mortgage rates would have helped significantly but mortgage rates moved only a little (see next slide).

US Interest Rates and Mortgage Rates



Source: US Treasury and HSH Associates, Financial Publishers.

GFA Reforms: Involvement of Emerging Markets (3)

- Federal Reserve had also expressed concerns about this. In Greenspan's last testimony to Congress in July 2005 he said, "The third major uncertainty in the economic outlook relates to the behavior of long-term interest rates. The yield on ten-year Treasury notes, currently near 4-1/4 percent, is about 50 basis points below its level of late spring 2004. …..This decline in long-term rates has occurred against the backdrop of generally firm U.S. economic growth, a continued boost to inflation from higher energy prices, and fiscal pressures associated with the fast approaching retirement of the baby-boom generation. The drop in long-term rates is especially surprising given the increase in the federal funds rate over the same period. Such a pattern is clearly without precedent in our recent experience…..The trend of mortgage rates, or long-term interest rates more generally, is likely to be influenced importantly by the worldwide evolution of intended saving and intended investment. We at the Federal Reserve will be closely monitoring the path of this global development few, if any, have previously experienced."

GFA Reforms: Involvement of Emerging Markets (4)

- In a paper with Pakorn Vichyanond published in 2006 (Directions of East Asian Regional Financial Cooperation. Asian Economic Papers, Vol. 5, Issue 3) we wrote, "The stubbornly low long term rates in the US could fuel future instability, particularly if there is a bursting of the real estate bubble in the US. It also seems clear that the Fed cannot easily control the yield curve in the US without coordinating with major treasure bill purchasers, which means that East Asian central banks need to be more proactive in coordinating with the Fed in influencing interest rates. Thus, East Asian countries do have a significant role to play in shaping the direction of the global financial system……They can help to stabilize possible problems, including real estate bubbles in the US. Given the current situation, the ability of the Fed to shape the direction of the global financial system is limited, and to maintain global stability it is time for East Asian countries to play a much more pro-active role. How this can best be done will obviously need a lot more thinking and discussions among the parties concerned."
- Not much thinking or discussions have occurred. May be the sub-prime crisis will get the relevant authorities to start thinking about this.

Thank You