The Orderly Resolution of Financial Crises – A G20-Led Initiative

How could a Leaders' Level G20 make a difference?

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BRIEFING NOTE

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Financial Crises and International Cooperation

International financial flows have expanded at a much faster rate than world GDP and international trade. For middle income emerging market countries, they represent the

On the other hand, investor sentiment can change suddenly and unpredictably, provoking large reversals in capital flows.[1]

The Mexican crisis of December 1994 which led to the collapse of the peso exchange rate, resulted in sharp declines in the stock markets of other emerging markets. Crises in Indonesia, Korea and Thailand in 1997 started a round of speculative attacks that affected other countries in the region and a number of countries in other areas of the world. Russia, Argentina, Brazil, Turkey are among the major countries that have recently experienced financial crises.

Under the Bretton Woods system, exchange rates were maintained by government economic policies, including controls on trade and capital movements to sustain the exchange rate stability. The Bretton Woods system was replaced by arrangements allowing exchange rates to float in the foreign exchange markets. The new arrangements intended to accommodate market forces result in frequent movements among different exchange rates.

Why do Financial Crises Happen?

Financial crises may result from poor domestic policies or from exogenous factors; in many cases they are the outcome of a combination of both. They occur more frequently than in the past because new categories of investors, such as hedge funds, are always seeking to improve their performance in order to retain the funds entrusted to them and to gain ground at the expense of their competitors. Thus, they are always ready to move in and out of markets rapidly, giving rise to rushes for the exit, often based on rumors and partial information. This gives rise to contagion, herding behavior and self- fulfilling speculative attacks.

As markets are freed from restrictions, they gain efficiency but volatility also increases. Empirical studies show that emerging market countries face a much higher volatility and vulnerability to exogenous shocks than either developed or low income countries. Whatever the differences in their economic structure, emerging market economies in different parts of the world are significantly correlated because of the behavior of investors.

Due to the large size of their portfolios, when the investment funds move money from one country to another, they may have a significant destabilizing effect on the smaller financial markets. While poor economic policies can provoke capital flight, it is also widely recognized, that capital flows to emerging markets are often volatile for reasons

[1] Financial crises are not exclusive to emerging markets. Recall the worldwide stock market crash of October 1987, the collapse of US high yield debt two years later, the September 1992 run on the British pound, the attacks on a number of other European currencies in 1993 that forced the realignment of the ERM (to 15%) and delayed progress towards European monetary integration, the failures of Baring Bros. and S.G.Warburg in 1994 and 1995 that forced the sale of both investment banks.

that that have little relation to a country’s policies. Among these are:

- Changes in financial conditions in industrial countries, particularly sharp unanticipated interest rate and exchange rate movements that increase the cost and diminish the availability of financing to developing countries.
- The pro-cyclical behavior of capital markets tends to undermine the creditworthiness of

ongoing dialogue between the Fund and the authorities to enable the country to approach the Fund at short notice, and to enable the Fund to respond promptly. Countries whose policies were considered appropriate by the Article IV consultation and had continued to pursue sound policies would be eligible for immediate experience a financial crisis.

Last year, net capital flows to developing countries rose to $241billion, an increase of some 37 percent over 2002 and are expected to remain at that level in 2004.[3]

Private sector debt and equity flows, which increased by a third, lay behind the rise. The recovery in capital flows has been heavily influenced by low interest rates in the industrial countries, as well as structural improvements and better economic management in the developing countries. Strong commodity prices also contributed to a favorable environment and to increasing the credit quality of developing country borrowers. Looking ahead, Latin America, with substantial external financing requirements and high levels of external debt, is particularly vulnerable to the risk of rising US interest rates that could trigger a reversal of current favorable external financing conditions. The possibility that a new financial crises may emerge in the next 18 months cannot be discounted.

If we see the risk of a crisis ahead of time, we should be able to act in a timely manner to try to prevent it. Among the early warning signs are rising spreads on external borrowing, the concentration of external liabilities in the very short term, a rapid decline in international reserves, commodity price, interest rate and political shocks. Surveillance coupled with a policy that ensures countries with good fundamentals have rapid and sufficient access to Fund and other resources when threatened by crises could replace the CCL[4]

. Other measures to reduce the foreign exchange risk of external borrowing should be developed. For example, portfolio diversification should allow markets and major lenders, including multilateral development banks, to lend to countries in their own currency.[5]

A code of conduct, as agreed by lenders and borrowers setting out mutual obligations, may also contribute to enhanced confidence and market stability. Among the unresolved problems to be dealt with by a G20 is the development of a cooperative approach for burden sharing by external creditors in the restructuring of unsustainable external bond debt.

Conclusion and recommendation

The policy stance of the IMF to financial crises needs to be revised and its resources enlarged. The Heads of State of the G20, considering international financial stability is a global public good, could bring about the necessary changes and as required, commit to provide additional financial support to members with sustainable policies,[6]

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[3] IMF, WEO estimates, September 2004

[4] Fund support would not avoid the need for adjustment but would provide time to effect it in an orderly manner and over a reasonable time.

[5] See paper by Randall Dodd "Up from Sin, A Portfolio Approach to Salvation" in the G24 web page: www.24.org/rpapers.htm

[6] In the technical judgment of the IMF

, should they face a liquidity crisis due to a speculative attack. To supplement Fund resources, the G20 could establish a network of readily available swaps or reciprocal credit lines. Similar support could be provided by the G20 to other emerging market countries whose policies are sustainable. In cases where the policies of a country that comes under a speculative attack were not sustainable, the country could receive prompt financial support in exchange for a credible commitment[7]
to enter into an appropriate adjustment program with the IMF. A credible commitment