MEETING THE CHALLENGES OF THE INTERNATIONAL FINANCIAL CRISIS

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I. INTRODUCTION

I had earlier been invited to focus on the Canadian proposal for enhanced surveillance of international financial systems. However, the depth and breadth of the current global economic crisis, rapid developments, and the scope of international response prompt me to be more expansive about Canada's and the G-7's, approach to the challenges of the global economy.

The international economy has entered a period of turmoil not seen for a very long time and it is far from easy to predict how long the uncertainty and volatility will last. What began as a financial crisis in Asia in the summer of 1997 has evolved into a broader and deeper global economic crisis which concerns and affects us all.

More than ever, in our search for solutions, all of our countries recognize our global interdependence. And, we also recognize that our domestic economies are increasingly affected by the overall international situation.

II. CAUSES OF THE CRISIS

While we are still looking for the right answers, we have gained some understanding of some of the factors that have led to this global crisis.

There is no doubt that the same rapid economic growth that caused Asian countries to be dubbed the miracle economies contributed to the Asian crisis. Over the past three decades, per capita income levels

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increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia. In Hong Kong and Singapore per capita income levels now exceed those in some Western industrial countries. And until the current crisis, Asia attracted almost half of total private capital inflows to developing countries over $100 billion in 1996.

So, given the many years of outstanding economic performance, how could the crisis occur? An IMF report tells us that Thailand, the first country to be seriously hit, experienced large macroeconomic imbalances, a marked slowdown in export growth, a current account deficit that was persistently large and financed increasingly by short-term inflows, and a real exchange rate that had appreciated to a level that appeared unsustainable in part due to circumstances beyond their control, as reflected in the wide swings in the yen-dollar rate. These problems, in turn, exposed other weaknesses in the economy, including substantial, unhedged foreign borrowing by the private sector, an inflated property market, and a weak and over-exposed financial system. These weaknesses reflected undisciplined foreign lending and weak domestic policies.

Developments in Thailand prompted market participants, especially those who had initially underestimated the problems, to take a much closer look at the risks in neighboring countries. It was evident that many of the problems in Thailand existed in varying degrees in much of the Asian region. These included overvalued real estate markets, weak and poorly supervised banking sectors, and substantial private short-term borrowing in foreign currency.

Markets began to look more critically at weaknesses that had previously been considered minor, or at least manageable, given time. Market doubts were compounded by a lack of transparency in financial systems. These systems were characterized by lax enforcement of prudential rules and inadequate supervision and associated lending practices that led to a sharp deterioration in the quality of bank loan portfolios, and problems of data availability. This hindered market participants from maintaining a realistic view of economic fundamentals and added to uncertainty about governance and political regimes. This crisis of confidence led to reluctance of foreign creditors to roll over short-term loans and caused downward pressure on currencies and stock markets.

In Asia, international investors looking for high yields underestimated the risks involved. The downturn in the health of the Asian economies and shifts in international competitiveness proved to make their investments unsustainable. Fears of contagion have surfaced in the current reality of Brazil, which remains vulnerable to external shocks, while it seeks salvation through tough fiscal measures and an IMF package. Brazil's proposed measures are aimed at reducing a mushrooming public sector deficit which is eroding investor confidence and inviting currency pressures. Success in deficit reduction would allow the government to lower benchmark interest rates from levels exceeding 40%. The high rates were adopted to forestall a looming currency collapse provoked by last August's turmoil in Russia.

The crisis in Russia reflects the confluence of three critical situations. First, as a resource exporter Russia has been severely affected by the fall in world commodity prices. The government's budget, already strained by poor tax collection, took a severe hit when oil export revenues fell. Second, was Russia's political crisis, where the continuing instability of successive governments has resulted in an inability to move forward with necessary reforms, including tax reform, better accounting practices and bankruptcy procedures, elimination of subsidies to unproductive sectors, and concerted effort to improve governance, both public and private. Third, the global *crisis of confidence* in emerging markets hit Russia—capital flight accelerated, pushing the ruble's value down sharply, and resulting in Russia's inability to pay debts, both public and private.

III. SEEKING SOLUTIONS

The G-7 and the international financial institutions are seeking solutions to ensure that international finance and the global economy can be managed to ensure stability and growth, to minimize adverse consequences including social impacts, and, to ensure the avoidance of crises.

Canada's Finance Minister, Paul Martin, stated in his October 1998 Economic and Fiscal Update: "Until recently we've seen and benefited from several years of significant economic expansion around the world. Now we are seeing globalization's other face. . . . Very clearly, the global economy has entered uncharted waters. This might well be the first real test of the stability and sustainability of globalization."

How are G-7 countries, including Canada, addressing the challenges of globalization?

The challenges are both immediate and longer term, covering the financial, economic, and social dimensions of the global situation and the interlinkages, both domestic and international.

On the financial front, we believe it is necessary to take immediate steps towards restoring confidence in the most affected economies. We must ensure our citizens enjoy systems that are safe, sound, and efficient. Prudential regulation, designed to require prudent conduct on the part of regulated financial institutions and to minimize the occurrence and cost of failures, is key, as are consumer protection and privacy issues, without intruding on the ability of financial institutions to operate as businesses.

We recognize that on the international front, concerns remain about the rapid increase and globalization of international financial flows. On balance, we believe that an open and liberal system of capital movement is highly beneficial. By facilitating the movement of savings to their most productive uses, liberalized capital flows can have a positive impact on investment and growth, and on economic prosperity. For these efforts to be realized, however, capital account liberalization needs to proceed in an orderly manner. Including an appropriate mix of macroeconomic and exchange rate policies, sequencing liberalization with structural measures, especially in the monetary and financial sector, and pacing liberalization to the circumstances of individual countries.

Cooperation and concerted action by like-minded countries is especially critical. That is why the efforts of the G-7 to strengthen the global financial system is so important. These reforms, begun at the 1995 Halifax Summit, have assumed far more meaning in the past year as we have all struggled to come to terms with the Asian financial crisis, which evolved into a global crisis.

Canada, as an active participant in the G-7 effort, has been particularly concerned about finding ways to ensure that international financial sector supervisory regimes become stronger and more transparent in order to lessen the likelihood and severity of possible future financial crises. Last spring, Canada proposed enhanced surveillance of international financial systems that could take the form of peer review. We brought this to the attention of APEC Finance Ministers in May at the meeting hosted by Canada in Kananaskis, Alberta, and to G-7 Leaders at Birmingham. This concept was widely endorsed, and was recently incorporated into a Canadian six-point plan to deal with the global financial turmoil, announced by our Finance Minister on September 29.

This six-point plan includes:

1. Ensuring appropriate monetary policy through G-7 central banks paying close attention and giving appropriate weight to the risk of a further slowdown in the global economy;

2. A renewed commitment by the emerging economies to sound macroeconomic and structural policy;

3. Expeditious action to strengthen national financial systems and international oversight;

4. Development of a practical guide or roadmap for safe capital liberalization in developing countries;

5. Agreement to work towards a better mechanism to involve private sector investors in the resolution of financial crises; and

6. Greater attention to the needs of the poorest countries to ensure they receive the resources and support they need to reduce poverty and begin growing.

This plan is designed to address the most immediate dangers by ensuring interest rates support continuing sustainable growth, promoting a sound policy environment in the emerging markets, and ensuring that the poorest countries receive support for poverty alleviation.

The Canadian plan is also designed to address the underlying causes of financial instability by strengthening financial sector supervision, ensuring that private investors bear their share of the financial burden during times of crises, and in helping developing countries to liberalize their capital markets safely and securely.

The elements of our six-point plan are reflected strongly in the Declaration by G-7 Finance Ministers and Central Bank Governors and a G-7 Leaders Statement on the World Economy, issued on October 30.

These statements highlighted various steps already being taken to strengthen confidence in the world economy, including progress made towards agreeing on the IMF Quota increase and the New Arrangements to Borrow; the reduction of interest rates by several countries including Canada, the USA, Japan, the United Kingdom, Italy, and several other European countries, to help maintain strong growth without jeopardizing commitment to low inflation; policy commitments by Brazil which the G-7 would support; a commitment of resources by Japan to strengthen the financial system; and progress made in Asian economies toward establishing the foundation for recovery.

Leaders also welcomed the Finance Ministers' proposals for immediate financing arrangements to ward off destabilizing market contagion, including establishing an enhanced IMF facility to provide, if necessary, a precautionary line of credit for countries pursuing IMF-approved policies, accompanied as appropriate by bilateral finance and private sector involvement; and agreement to establish a World Bank facility to provide, in times of crisis, support for most vulnerable groups, financial sector restructuring, and increased use of financing tools to encourage private flows.

The G-7 Leaders and Finance Ministers did address longer term architectural reforms for the global marketplace that would capture the full benefits of international capital flows and global markets, minimize the risk of disruption, and better protect the most vulnerable. These longer term measures include global action to promote greater openness in the financial operation of domestic financial and corporate institutions, and IFIs, including through internationally agreed codes of good practice to increase transparency of governments' fiscal and monetary policies, and to strengthen corporate governance; enhancing surveillance of national financial and regulatory systems, with better cooperation between national authorities and key IFI and regulatory bodies; orderly and progressive capital account liberalization; cooperative resolution of future crises, particularly mechanisms to involve the private sector; and principles of good practice in social policy and the development of adjustment programmes to protect the most vulnerable groups in response to crises.

Leaders called on their Finance Ministers and Central Bank Governors to also pursue further proposals to strengthen the financial system, including strengthening financial systems in emerging markets, establishing a process for surveillance of the international financial system, maintaining sustainable exchange rate regimes in emerging markets backed by macroeconomic policies that promote stability, developing new forms of official finance and promoting a greater role for the private sector in addressing crises, and encouraging policies to minimize the human cost of financial crises.

Canada was particularly insistent that the G-7 Leaders' Statement include reference to the impact of the crisis on the poor and most vulnerable, the need to engage the private sector in restoring financial and economic confidence, and the importance of open markets through trade and investment liberalization within the framework of the WTO.

On the broader economic front, we are working to maintain and foster sound economic fundamentals that build strong and resilient economies. The macroeconomic prescription reduction of deficits, keeping interest rates and inflation low is being encouraged. We are also working to promote business climates conducive to the development of SMES and enhanced job creation. We recognize the need to put in place policies that ensure a smooth transition to a more knowledge-based and technological society.

And we must also keep markets open. This involves actions designed to restore the conduct of business such as opening lines of credit, delivering on our intentions to keep markets open, and making progress on APEC early voluntary sectoral liberalization. We are mindful of carefully managing public expectations through engagement with civil society.

Increasingly, we recognize that financial and economic crises have social consequences and that, as stated by Joseph Stiglitz of the World Bank, the poor and most vulnerable often carry a disproportionate burden. In the short term, on the social front, it is important that aid to most affected countries is appropriately targeted given fiscal constraints and the drying up of capital flows. As need arises, bilateral and/or multilateral efforts will be undertaken for food aid and distribution (or other forms of humanitarian assistance) to hard-hit countries such as Indonesia and Russia.

IV. THE CONTINUING AGENDA

Our work is not over. We recognize that reform of the international financial system is an ongoing process. The momentum for reform begun in Halifax in 1995, and reaffirmed at Denver, Birmingham, and in the recent G-7 Statement, must be maintained. We also recognize that the global crisis has longer term and wide-spread impacts, not only on the financial and business communities but on the lives of the citizens of affected countries. There are, therefore, many issues that we continue to grapple with in our search for solutions.

On the financial front, we must, of course, be vigilant in ensuring effective implementation of the G-7 Finance Ministers' and Central Bank Governors Declaration. We will be tackling difficult issues and posing challenging questions as we continue the agenda to reform international financial tools to ensure global economic stability and growth.

> 1. Is there agreement that the IMF should be policeman more than fireman, since we cannot sustain, politically or economically, the funds necessary to make it a lender of last resort?
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> 2. How do we ensure the optimum effectiveness of our Bretton Woods institutions? What are the most compelling options for refocusing, refining, or redesigning them?
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> 3. How do we achieve overall architectural coherence between the IMF, World Bank, Asia Development Bank, European Bank for Regional Development, and other international financial institutions?
>
> 4. What prescriptions should be offered regarding capital account liberalization and exchange rate volatility?
>
> 5. What further steps could be taken to address the private sector moral hazard issue?

We need to address the general malaise associated with globalization.

> 1. How can we provide a solid foundation for new WTO negotiations, and build support for the development of an agenda for trade negotiations?
>
> 2. What are the most effective actions to be taken to encourage the modernization of governance structures?
>
> 3. How can we promote most effectively the results of the OECD work on corporate governance expected next spring.

To deal with the social impacts, it is important that the social consequences of the economic and financial crises be addressed.

> 1. How could the G-7 scope be broadened to address social impacts and adjustment measures in affected economies?
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> 2. How can we most effectively encourage the development of social safety nets and skills development in affected economies?
>
> 3. How do we achieve more buy-in and coherence across international institutions and fora? How do we foster a greater role in the area of social impacts for the OECD and APEC?

V. CAPITAL ACCOUNT LIBERALIZATION

In view of the observations offered by the other panelists, permit me to share some personal views on recent proposals to amend the IMF Articles of Agreement to give the Fund an explicit role to promote capital account liberalization. I understand that capital account liberalization in this context refers to removal of restrictions on inward and outward flows of investment and other types of capital, including cross-border flows of stocks, bonds and bank deposits. I also understand Mr. Holder's remarks to suggest that current proposals might exclude direct foreign investment from the purview of the proposed IMF oversight of liberalization.

In my view, it would seem appropriate to have the Articles of Agreement recognize explicitly that liberalization of international capital movements is a "specific purpose" of the Fund. I believe, however, that much more analysis is needed before giving the Fund more specific rule-making or enforcement role, for several reasons.

First, several international fora have some oversight of international capital markets, including the WTO, the BIS, and the OECD. As suggested by my question on international architecture earlier, we should be working towards an appropriate division of labour between relevant international organizations active in the area.

Second, taking the financial sector as an example, many countries permit capital movements to be constrained in circumstances where prudential supervision demands restraint. Indeed, the NAFTA explicitly recognizes prudential exceptions to liberalization of financial services activities. In considering oversight, we should ask whether the IMF is better placed than other international bodies to assess the legitimacy of such measures.

Third, speaking from some experience as a trade negotiator, I would note that the NAFTA, as well as U.S. bilateral investment treaties (BITs), Canadian Foreign Investment Protection Agreements (FIPAs), and thousands of other bilateral investment agreements around the world provide for investment liberalization, with implications for the capital account, subject however to explicit and diverse exceptions. Excluding direct foreign investment from IMF rule-making may not be sufficient to afford full respect for the exceptions in these agreements (for example, U.S. legislative restrictions on foreign ownership of newspapers or airlines), since the agreements cover both portfolio and direct investment.

Fourth, even if filing of exceptions were to be contemplated, experience suggests that these kinds of restrictions are more effectively liberalized in the context of bilaterally or multilaterally negotiated reductions. Even if such exceptions were permitted, absent significant new resources for administration and dispute settlement, the IMF would not appear to have the institutional capacity to resolve differences that may arise.

VI. CONCLUSION

In a recent article entitled Glimmers of Hope, Jeffrey Sachs stated: "Financial crises are tragic and largely unnecessary, short-run phenomena. It bears emphasizing that East Asia's and the rest of the world's, challenges will not end with the end of the financial crisis. In fact, the true hard work will begin again." We recognize that it is a fact of our rapidly changing and challenging global economy that "the true hard work" never really ends, that there are always more and different questions to grapple with, and, hopefully, that there are new and innovative solutions to be put into real effect.