

Comment^{*}

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1. Introduction

Stanley Fischer and Carl-Johan Lindgren provide a thoughtful discussion of the issues raised by the transformation of world capital markets, with respect to the role of government-like international economic institutions like the International Monetary Fund.

The paper starts with the view that a sound financial system is a precondition for stable economic growth especially in emerging markets, and stresses the role of government supervisory authorities in safeguarding the financial system. It explains the activities of the Fund in the field of financial systems, and its objectives for the immediate future. The paper concludes with a summary of the Fund's own work on a framework for financial stability, which among other things outlines a set of guidelines for financial sector surveillance.

In my comments I will, in a sense, expand the horizon of the Fischer-Lindgren paper by discussing the question of the appropriate role of an institution like the IMF: what are the historical and economic reasons for it to become an international financial overseer? In my conclusions I will point out that there are many sound arguments to transform the IMF into an international financial overseer. However, there are also many unresolved questions on what exactly could be the IMF's mandate in such a new or transformed role.

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* All opinions expressed are the author's only.

2. The evolution of the role of the IMF

The role for the IMF has evolved as a reflection of the changing world financial markets. It was born in the aftermath of World War II when capital controls were pervasive among industrial countries. In addition, financial intermediaries were, in the practical totality of the world, heavily constrained in their investment and financing decisions. In such a market, dominated by payments restrictions and restrictions on financial intermediaries, liquidity becomes an important public good.

Indeed, the IMF started its activity as the leading international liquidity provider. Balance-of-payments financing is a key problem in countries where exporters and importers cannot finance international trade, where the foreign exchange market is the monopoly of the central bank. The central bank becomes the provider of foreign exchange and it may find itself unable to buy it at a given price.

The successful pursuit of macroeconomic adjustment programmes was, and is, the condition for the release of IMF financing. Thus, the IMF quickly found it necessary to develop knowledge to be able to effectively assist countries in the framing of their adjustment programmes. Hence the role of liquidity provider came along with and contributed to the growth of the role of macroeconomic advisor.

It is with the experience of the major adjustment programmes of industrial countries of the 1970s that the role of the IMF as an advisor increased and at the same time acquired new functions. Its status as an international institution largely independent from various domestic political parties and its effective technical knowledge on macroeconomic issues made the IMF the guarantor of the desirability of otherwise unpopular policies.

In correspondence with the international financial crises of the late 1970s and early 1980s it became apparent that the IMF is also the main signaler that the chances of a country turning around were higher if it approved of its policies and sponsored them through the appropriate financial facility.

The growth of world capital markets and progressive dismantling of capital controls showed that these different roles of the IMF (provider of liquidity, macroeconomic advisor, guarantor of the desirability of unpopular policies, signaler of the improving credit condi-

tions of a country) could be performed separately. Indeed, countries with more efficient capital markets and international capital flows were more relying on the role of the IMF as a signaler and an adviser than as a liquidity provider.

Whence the role of international financial overseer? Fischer and Lindgren claim that, *de facto*, the IMF has already performed that role. I agree with their claim. It is apparent that large-scale financial crises do have potential international systemic implications. Indeed, the United States government has referred to such systemic risks explicitly when explaining to the public its initiative to organize the bailout of Mexico. Thus, it would appear that the IMF is, in its function as an international institution that is in principle independent from any one single country, ideally suited to deal with the systemic international problems caused by large scale financial problems.

In the rest of my comments I will discuss the issues that need to be tackled when trying to convert the broad justifications for the need of an international regulator/overseer to the practicalities of implementing such an institution.

3. The causes/channels of externalities: from hunch to policy

Appropriately, Fischer and Lindgren stress the important role of macroeconomic phenomena (there is, strictly speaking, a bit of a tautology here, since all externalities are aggregate phenomena ...). Yet, the stress on some key macro phenomena is correct both because of their importance and because the IMF does have special expertise on macroeconomic problems and policies and thus it is natural for them to start from macroeconomics.

Consider a country that finances domestic investment with international capital. This country, by definition, runs current account deficits. These payment imbalances are one of the main channels of interaction of macroeconomic and financial risks in emerging market investments.

We know that a good investment – a positive net present value investment – does not give rise to any problems if it is financed overseas, i.e. if it contributes to a widening of current account deficits.

Yet, countries that run large current account deficits are perceived as countries that will need adjustment soon. Thus, even good investments could contribute to the macroeconomic fragility of a country. This conjecture would involve a significant amount of analysis to yield to a convincing argument about the nature and the role of externalities in international capital flows. Such analysis does not fit this short comment. Here I just want to point out that the aggregation of investment activity into current account deficits could be an important channel of systemic risks in emerging markets.

Another relevant, and well-known, macroeconomic phenomenon that could be the source of externalities is related to short-run, monetary policy issues: in regimes of pegged exchange rates many institutions (typically domestic financial institutions or corporates) are heavily involved in convergence trades (borrowing overseas to lend domestically). We know from the literature that such situations could lead to multiple equilibria. Such equilibria can be characterized by different aggregate welfare levels, as well as different distributions of wealth.

It is apparent, from the hunches provided above, that their distance from appropriate policy decisions or institutions is vast. And yet, the only way to identify the role of government institutions is to identify in a clear way the market failures. The hunches above are a lead in what I think is the right direction, but only a lead. It is interesting to notice that the now large and growing policy literature on these issues does not seem to prefer this approach.¹

There are other distortions that come to mind when considering the phenomenon of international financial crises which add to the list started above. These are more proper microeconomic phenomena, and have to do with the propagation of financial crises. A proper study of these requires the description of the behavior of actors that are most involved in local currency markets. These actors are typically institutions that have privileged informational access to local markets, as well as financial access to them. Local financial intermediaries and multinational corporations are the typical examples.

The list is completed with a sub-list of domestic externalities and market failures. In this area, the Report of the *Working Party on Fi-*

¹ See, for example, J. Sachs, "Alternative approaches to financial crises in emerging markets", mimeo, HIID, November, 1995.

nancial Stability in Emerging Market Economies, the so-called Draghi Report, contains a list of the most common failures in emerging markets. It includes:

- lax management of financial institutions. This stems from poor internal controls (poor technology in financial intermediation) and bad incentives, perhaps due to government ownership;
- weakness of the legal framework to enforce property rights;
- regulatory failure, and often regulatory capture;
- market illiquidity.

Illiquidity is in reality just the equilibrium implication of the many distortions listed above. In the absence of sound financial institutions, sound rules to enforce investors' rights, sound regulations to safeguard investors, it is only natural that risk capital markets cannot grow, because they are supply-constrained. Since however the total amount of risk in countries cannot endogenously decrease much, it is also very likely that in such circumstances risky investments are borne by institutions that are not equipped to do it.

The appropriate activity of the Fund in its role as an international financial overseer should be to analyse, understand and help tackle the problems listed above. Fischer and Lindgren mention two things the Fund could do: explain authorities how to set up institutions and disseminate best practices.

It seems to me it is quite difficult to be more ambitious than this. On the one side, the complications of the distortions at the root of financial fragility or instability is such that there cannot be great confidence of the potential of any proposed government solution to be one hundred percent effective. On the other hand, too much activism by governments and government institutions gives rise to a host of well-known moral hazard problems, which make financial systems weaker, not stronger. Finally, in countries characterized by several important and interrelated distortions there are difficult problems of sequencing that need to be resolved.