

Comment

ENZO GRILLI

In addressing the issue of surveillance, international standards and the role of the IMF, I have the good and the bad fortune of being the last speaker. On the one hand, I have heard what everybody has already said and I can avoid repeating it. On the other, some of what I wanted to say has already been said. Let me start where the previous speaker left off, i.e., with the role of international financial institutions. Whenever an episode of financial fragility emerges, and it threatens to spill over and become systemic because of its effects on asset prices and international credit, for example, some questions inevitably arise. Were we surprised by it, and if so, why? Where were the sentinels? Why did they not alert us? Another question, which is perhaps the most important, is who is going to 'take care' of this now? Who is going to help in the specific crisis, preventing contagion, and ensuring that it does not cause too much damage?

At a certain level these are fundamental questions, but at another they can become quite trivial. In a world that is imperfect, where a system of collective financial security is not in place and where market crises do arise, often unanticipated, the question of the identity and effectiveness of the 'institutional sentinels' should be posed with circumspection. Markets themselves, if well functioning, should provide the early warning signs. Markets should be able to supply accurate and timely evaluations of risks: corporate risks, sector risks (e.g., banking), country risks, and the like. Markets, finally, should allow a wide sharing of these risks, i.e., minimize concentration of them in one or few agents and places. But their ability to do so is obviously far from perfect. Thus, one cannot ignore market failures when they occur or arbitrarily attribute the 'sentinel' function to somebody, and

□ IMF and Johns Hopkins University, Washington (USA).

in particular, to institutions that do not have it and cannot perform it under present rules. This becomes illusionary, or worse.

If the financial crises are big enough, the next question, often asked, is who will lead at the international level the 'institutional' response to it? The fact to remember here is that we do not have in place a system of collective security, economic or financial, in today's world. We may wish that such a system existed (or we may wish the contrary), but it is certainly not in place now. We do not have an international financial fire brigade that is ready to intervene every time there is a fire, from Borneo to Tierra del Fuego. What is there, is a system of international cooperation, voluntary and patchy, which works reasonably well in some circumstances, but needs to be activated on a case-by-case basis and guided. And capacity to guide – leadership – is unfortunately a scarce commodity. We have global institutions – such as the International Monetary Fund, the World Bank, the World Trade Organization – but with many different mandates, different instruments at their disposal and incomplete jurisdictions even in their respective spheres of activity. They can take care of some aspects of the world economic order (respectively, international payments, investment capital and trade), but they do not constitute, singularly or collectively, a 'system' for dealing with financial crises. So, let us not ask questions about institutional responses, when we have not put in place the necessary institutional framework. Such questions are really quite useless.

At the global level, we have the IMF that deals with the issues arising from international payments. As Giovannini already noted, the IMF was set up to provide stability in the payment system. However, the types of payments that the Funds was set up to liberalize were those arising from current account transactions. The Fund *still* has no mandate over either capital accounts transactions or payments connected to it, let alone oversight over national or international banking activities. The Fund has reinterpreted its mandate, given that it lives – like all of us – in a world that constantly changes, and has extended it to cover all the *basic conditions* for ensuring that a payment system can work. These are largely conditions of macroeconomic stability at the national level and of policy compatibility at the global level. Stability is a public good. It yields benefits to everybody, but it does not come automatically. Nor can it be ensured from the outside by the IMF or others. The advice and assistance that the Fund can – and does – provide to member countries, the suasion and sur-

veillance that it can exercise, are no substitute for the right policy determinations at the country level.

In the system of international cooperation that exists now, stability requires sound and credible macroeconomic financial policies at the country level. Financial instability is largely generated, or at least greatly facilitated, by domestic macro imbalances that reveal unsound and inconsistent policies and by expectations built upon them. There are other causes, or other factors that help them, but macro outcomes (actual and expected) are generally important for their direct effects on the financial systems and on expectations of market players.

This morning someone was lamenting that good leading indicators of financial crises do not yet exist. Of course, there is no such thing as an indicator that can tell us when a financial crisis will erupt, but there are indicators that can tell us that the likelihood of a financial crisis is increasing or decreasing. If you have current account deficits which are large and becoming larger, if you have an exchange rate that is grossly overvalued, if you have a large and growing foreign debt (public or private), you know – or should know – that you are much more at risk than somebody else who does not. Obviously one cannot pinpoint when a crisis will happen and how, or where it will happen first. Mexico in 1994 is a case in point. The basic indicators signaled the danger clearly, even if market participants did not weigh them properly. Thailand was another case of the same syndrome in 1996. There is not a great deal of mystery about where the risks of financial instability are, or about their direction. What is more difficult to tell is when market reactions to them will commence and when hedging and speculative behaviors will be triggered.

Aside from good policies, financial stability implies good national institutions. Institutions that have the right mandate, that operate within the right framework, that can speak independently and act autonomously, and that actually act with the public good as their objective. You need independent central banks at work, you need good supervisory authorities, you need bankruptcy laws, you need good civil courts. You can do without some of them for a while, but then a price for underachievement in these areas comes due. Yet, growth and apparent success is often blinding. It obscures the institutional weakness of entire economies for relatively long periods of time, in much the same way it obscures policy inconsistencies.

Stability also implies capacity to access outside credit resources in time of crisis. When shocks arrive, a resource buffer can make a great deal of difference in the timing and characteristics of the response. But, availability of foreign credit, like national foreign exchange reserves, is never sufficient in itself to cope with a serious shock, particularly in the absence of confidence, generated by the presence of large and growing imbalances and by vanishing policy credibility.

If macrostability, good institutions and access to resources in time of crisis are important to country macroeconomic and financial stability, and are thus antidotes to financial crises, then how can the IMF contribute to the creation or preservation of this public good? The standard answer is that the IMF can contribute by improving macro and financial sector policy formulation and policy implementation at the country level. And it does so, by giving advice on a regular basis and by supplying credit to member countries that want to undertake adjustment policies which have costs, before and after crises have occurred. Its financial assistance smooths out these costs, making them more bearable.

Moreover, the Fund can contribute to stability by 'certifying' policies and achievements of members countries, acting in this fashion as a direct supplier of internal and external 'credibility'. Giovannini was talking about an IMF function as a public international 'overseer'. One can indeed argue that when international financial markets are able to provide more capital to countries, the importance of the IMF as a supplier of finance to deal with balance of payments problems should decrease, and its importance as an external monitor should increase. There is logic to this position. There are externalities in the provision of information, and the private sector has only a very limited ability to enforce conditionality. So here is a role that the Fund can perhaps take up with greater emphasis than in the past, if indeed there is the necessary consensus of member countries for it.

Finally, the IMF can contribute to the creation of good institutions at the country level. I shall not repeat what has already been said by Lindgren and others. By transferring experience, by spreading best practices, by extending technical assistance, by facilitating the diffusion and adoption of good standards, the Fund can foster national and international stability. This is all granted.

The Fund has, in addition to all of this, a pool of resources that it could conceivably make available to members on an emergency ba-

sis in times of financial crises, although this is not the main institutional purpose for which the Fund was created and member countries' resources were pooled. But in my view, to find justification for this role and avoid - or at least contain - large moral hazard risks, the supply of credit to countries facing financial crises should only be made in the presence of adequate policy actions taken at the national level, and not irrespectively (just because there is a crisis). It would be very unwise, aside from 'unconstitutional', for the Fund to act like a fire brigade that intervenes providing 'liquidity' in crisis situations and stops at that. Before this occurs, there must be something in place that affects the policy behaviours of countries and that changes the responses of private players in financial markets, domestic and foreign. Adjustment in policies, institutions and regimes must be supported, and not delayed by IMF intervention. Adjustment costs in crisis circumstances are unavoidable. They can only be minimized by careful planning, and smoothed out by recourse to outside finance. Another condition for granting access to emergency credit when financial crises arise is that IMF action must reduce the risks of contagion, i.e., minimize the diffusion of these crises to the rest of the system. This is the public good dividend that must be earned by these actions. Financial crises that do not involve systemic risks should be dealt with otherwise, nationally or perhaps regionally. Finally, Fund interventions should be such that the reward-risk-penalty relationship is not broken. A fair portion of the losses that are usually involved in financial failures must be shouldered by market players. IMF intervention should be discretionary and cover only the minimum amount of private risks. Otherwise, moral hazard is expanded in time and place.

The final point that I wish to emphasize, which was, I think, much underplayed today, given the focus on surveillance and international cooperation, is that the main responsibilities for maintaining financial stability lie at the country level and should remain there. Outside assistance cannot substitute for domestic action. Apart from problems of mandates, institutions and rules of international cooperation, activities bearing on financial institutions, regimes, macro and sector policies are inherently internal, within the primary domain of national authorities. So let us now ask the Fund, or any other international organization, to do things not only that they were not set up to do, but also that they could not do effectively even if asked. *A chacun son métier!* Put it more plainly, let a proper 'division of labor' apply.