Timothy F Geithner: The Bretton Woods institutions in the 21st century

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Bretton Woods Committee, New York, 10 June 2004.

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It is a pleasure to join you for this meeting of the Bretton Woods Committee. This is a great and accomplished organization. Although the international financial institutions are one of the most important legacies of the great statesmen of the last century, the task of supporting them is not always easy. The Committee has been effective in this role, not just by helping to explain the accomplishments of the International Monetary Fund and the World Bank to an occasionally skeptical public, but also by helping to shape the debate on how these institutions need to change.

The Fund, from its inception, was burdened by a mismatch between the aspirations of its architects and the authority and instruments they gave the institution to pursue those ambitions. Its authority over the policies of its members was limited. Its resources were small, and the facilities established to deploy those resources were modest relative to the problems they were designed to address.

At its creation, the architects of the Fund hoped to build a system that would deliver exchange rate stability globally, in a world much less integrated than it is today, without giving the Fund the capacity to induce, much less compel, its members to pursue the economic policies that might have made that objective more realistic. They gave the IMF a financial mission that had some of the characteristics of a lender of last resort to sovereigns, but without mechanisms to constrain risk-taking behavior. By necessity, they left the Fund in the position where it was ultimately dependent on the strength of the governments of its members, and on their willingness to act to address their economic challenges.

To their credit, the founders gave the institution a basic charter that permitted evolution. And as the needs of the world have changed, the institution has been able to change as well. It has been much more responsive to change, and much more agile in responding to a rapidly changing mix of challenges than other multilateral organizations. But the constraints that were established at the outset still exist today.

I am going to focus, in my remarks today, on the Fund's role in promoting financial resilience and mitigating crises in emerging market countries. But first, let me mention briefly several of the other areas where the Fund has a very important role to play in the international economy and financial system. The Fund can provide a useful voice and a forum for advising the major economies to pursue policies that can contribute better to global economic expansion and financial stability. The Fund can play an important role in considering, from a global or systemic perspective, the exchange rate policies of its members. And the Fund plays a vital role in providing the macroeconomic policy framework that is the critical to sustaining better growth outcomes and the effectiveness of the global development assistance effort for the poorest, low-income countries.

I think the Fund is reasonably close to the frontier, the sensible or achievable frontier, in these areas. Some may wish it were more effective in persuading the G-3 to avoid policies that create the risk of abrupt changes in financial market conditions or exchange rates, but it will never be decisive in this arena. And it might do more to further improve the design of macroeconomic policies and institutions in the poorest developing countries. But outside those areas, the challenges to sustained growth in per capita income lie largely in areas beyond the core competence of the IMF.

In the emerging market context, in contrast, there is greater distance between the Fund of today and the achievable frontier. This is a timely and critical issue, because of the magnitude of the challenges that still confront many emerging market economies.

Let me start with a broad review of the progress made over the past decade across emerging markets in reducing their vulnerability to financial crisis.

- International reserves have increased substantially, providing a larger cushion against adversity. Among the largest borrowers, half now hold reserves greater than 150 percent of maturing short- and long-term debt; less than one-sixth had such coverage heading into 1997.
- There have been improvements in fiscal performance, with some notable cases of governments achieving and sustaining large primary surpluses.

- External balances have improved, with current accounts in most of the emerging world in surplus or modest deficit. Only 2 of the 20 largest borrowers now are running deficits in excess of 3 percent.
- Exchange rate regimes are more resilient and less fragile, as a substantial majority of the largest borrowing countries have moved to flexible regimes, and away from the fixed-but-adjustable pegs that proved so dangerous in the crises of the last decade.
- Important progress has been made in building credibility for new monetary policy regimes, and inflation is generally moderate.
- Governments have made major investments in recapitalizing and restructuring their troubled financial systems. For example, in Asia, where some of the most severe problems were encountered, governments have spent over $500 billion carving out problem loans and bolstering capital.
- Growth rates have improved with the restoration of domestic stability and recovery in external demand. Indeed, aggregate growth currently is running at its highest rate since the onset of the crisis in 1997.
- With these improvements, and generally accommodative external financial conditions, borrowing costs have fallen, capital market access was restored for many countries, and credit growth resumed. Net credit growth to sovereigns has remained moderate, however, as much of the borrowing has gone to refinancing the existing stock of debt on more favorable terms.
- The market for emerging market debt also has matured. There has been more differentiation in the response of spreads, both on the way down as credit fundamentals seemed to improve, and during the recent correction.

This progress is indicative of a general increase in the sophistication and skill of economic policy makers in the emerging world, and in the quality of understanding of the benefits of macroeconomic stability and how to achieve it. Many countries benefited from the advice and financial support from the IMF and the multilateral development banks. But the most successful were those with policy makers who were ahead of the Fund and the Bank in diagnosing and addressing their problems, rather than being dragged reluctantly toward a more credible policy stance.

These improvements have left the emerging markets as a group less vulnerable to financial crisis than they were in the mid-1990s. The combination of deeper reserve cushions, stronger external positions, improved balance sheets, more flexible exchange rate regimes, and better inflation performance provide a very different setting from what existed the last time we faced a transition after a sustained period of benign financial conditions and low interest rates.

These aggregate improvements mask substantial differences across countries and a number of areas of lingering vulnerability. Let me highlight some, and then suggest some implications for how the Fund might better position itself to deal with the challenges they present.

- Some of the most daunting challenges are in the fiscal and public debt area, where a number of emerging market economies across different regions face very high, and in some cases still growing public sector debt levels. Average public debt burdens in the emerging world have risen to about 70 percent of GDP, and among countries rated single B and below, the mean rises above 80 percent.
- The challenge of managing debt burdens of this size is magnified by the fact that the debt structures in a number of countries are still quite vulnerable to foreign currency, liquidity, and interest rate risk. The substantial share of public debt denominated in foreign currency - 70 percent on average for the lowest rated group of borrowers - and the relatively short maturity of the debt stock mean that a relatively modest shock can produce a substantial increase in debt burdens, raising the amount of fiscal effort needed to keep the debt stock on a stable or declining path, and increasing the economy’s vulnerability to a crisis.
- In some countries, the fiscal trajectory is too weak to place the debt-to-GDP ratio on a sustainable path. In others, the fiscal position is strong enough to stabilize the debt dynamics, but provides little buffer against adverse shocks, and very little room for fiscal policy to help cushion the effects of such a shock.

- Important challenges remain in the financial area as well. In many countries, large public sector debt burdens have left banking systems highly exposed to the sovereign, constraining authorities' room for maneuver. There are also problems in banks' corporate and consumer loan books, and a number of banking systems also have a large share of foreign currency denominated liabilities, in some cases held by non-residents.
- The durability of recent improvements in external positions, which reflect weak domestic demand in many countries, is also open to question. As domestic demand strengthens, external balances could move into deficit again, which in some cases will reintroduce a greater external risk.
- And in many cases, the financial exposure of the IMF and the multilateral development banks is already high.

These balance sheet challenges took a long time to develop, and they will take a long time to reverse. They are the legacy of years of past fiscal decisions, magnified by the impact of crises on growth, the exchange rate, and the financial sector. They leave an exacting set of policy challenges. They raise the risk that future shocks to domestic confidence or adverse changes in the external environment could lead to new pressures on exchange rates, on interest rates, and on the capacity of countries to fund themselves on sustainable terms. Apart from the risk of crisis, these debt levels are large enough to depress domestic investment and long-term growth prospects.

In part because of these balance sheet and debt burdens, many emerging market economies face a protracted transition before they can expect to be comfortably considered stable investment grade credits, with sufficient levels of self-insurance against external and domestic challenges to financial stability.

One of the most pressing challenges for the Fund is to help assist in this process of reducing vulnerability, by promoting an unwinding of these large balance sheet risks and, at the same time, providing a credible form of contingent insurance for those hopefully rare circumstances when its members face extraordinary financing needs.

The Fund would be better able to contribute to this process if it were to strengthen its policies in a number of specific areas. My suggestions cover four types of reforms: changes to the substantive focus of Fund policy advice; to the relationship between the Fund and its members in the surveillance framework; to the Fund's approach to countries undertaking a debt restructuring; and to how the Fund uses its financial resources. They involve adopting: a risk based approach for focusing the Fund's crisis prevention work; a more intensive framework for the surveillance process to provide a stronger anchor for the member's economic program; a reinforced framework for providing support to countries undertaking a debt restructuring; and a more credible form of financial insurance that creates better incentives for stronger policies in advance of crisis.

These proposals do not require amending the Articles of Agreement of the Fund, and can be achieved without major changes in the structure of the institution. They are evolutionary rather than revolutionary.

More policy ambition

Studies by IMF staff, the IMF's Independent Evaluation Office, and others catalogue a number of criticisms of the substantive content of the Fund's policy advice. Many of these studies conclude that the Fund has had insufficient ambition in its prescriptions for reform and in a number of cases was too deferential to domestic political constraints on adjustment and reform. Some conclude it was too supportive of choices by its members to run exchange rate regimes that were incompatible with the rest of the policy framework, that led to substantial appreciation of the real effective exchange rate over time, that encouraged borrowing in foreign currency, and that proved too brittle under stress. Some suggest the Fund was in some cases insufficiently attentive to or ineffective in addressing the increases in debt, particularly foreign exchange denominated and linked debt, that created the balance sheet problems, which made crises so damaging and difficult to resolve. It accommodated, if not supported, decisions by its members to calibrate policies designed for a more benign external environment than was realistic and therefore encouraged less self-insurance than was necessary to manage safely. And it was drawn too far into a range of efficiency-improving long-term institutional reforms that necessarily diffused attention from critical vulnerabilities.

To some extent, these criticisms suffer the classic failure of claiming that what seems obvious in hindsight was as clear at the time. Many are unfair in the degree of influence they expect the Fund to be able to exert over a reluctant member - recall the constraints I described at the beginning on the Fund's powers over its members. And many of the criticisms fail to recognize the difficulty of making definitive judgements about the path of policies consistent with sustainability.

Yet elements of this general diagnosis of the Fund's policy advice to emerging market economies have substantial merit. If the Fund is going to contribute to a process of well-targeted reform, particularly in the more vulnerable countries, it probably needs to raise the bar, to increase the level of ambition of its policy recommendations. Greater policy focus is required on the principal sources of near-term vulnerability, ideally without fully eclipsing longer-term institution building and structural reforms important to raising growth potential.

A risk-based framework for determining the hierarchy of policy priorities is important. Such a framework would almost certainly entail more focus on unwinding large balance sheet problems (both with respect to the sovereign and the financial system), reducing sovereign debt to more sustainable levels, making debt dynamics less vulnerable to shocks, increasing liquidity buffers, and preserving appropriate exchange rate arrangements. Addressing these issues would help reduce the risk of future capital account crises. It would create better conditions for private sector growth. In virtually every context where public sector debt burdens are high and fiscal deficits large, more ambition in the adjustment path should be positive for growth through the effect on confidence, interest rates, and the exchange rate.

Of course the Fund can't want reform more than its members. The principal burden for running a set of policies more commensurate with the risks emerging markets face in this world rests with their governments. The role of the Fund should be to help guide and encourage them to the point where they build in a more substantial degree of self-insurance. The Fund should not acquiesce in and validate policy frameworks that fall substantially short of the threshold necessary to safely navigate this world of high variability in the external environment and occasional domestic political pressures to weaken policies.

Changing the surveillance framework

Part of the challenge entails reorienting surveillance, the process through which the Fund's policy advice is delivered, to make it more effective. The surveillance framework of today has a number of features that make it poorly suited to a small open emerging market economy that has fragile credibility, a limited buffer against shocks, and considerable exposure to a rapidly changing economic and financial environment. The assessments occur quite infrequently, only every 12 to 24 months. The assessments can only be published with the approval of the member state, which tends to take the edge off the diagnoses and prescriptions. Assessments do not come with a clear evaluation relative to thresholds that help define degrees of vulnerability, or relative to other countries in similar circumstances. The assessments are judgments of the Fund's Executive Board, not formally of the staff, which can also work to take the edge off candid economic and financial judgments. Risks are not clearly and candidly identified and explored. And the process does not come with consequences, since critical evaluation can be withheld from the public, and neither favorable nor critical evaluations necessarily have consequences for access to financial assistance from the Fund.

The model we use for bank supervision in the United States offers an interesting contrast. We undertake a continuous process of onsite examination. We use a risk-based framework for focussing attention on critical factors. We produce a confidential rating of select dimensions of the financial profile of the institutions and their risk management and control infrastructure. We assess the models banks use to measure risk and the scenarios used to stress test exposures, but the banks have the responsibility for designing and running the risk management infrastructure. By looking across a broad range of world class financial institutions, we have a good sense of the evolving frontier of best practice in risk management which we can then use to help benchmark other institutions and pull common practice closer to that frontier. For a number of reasons, this can't be the model for the Fund's relationships with its members. But it provides an interesting prism in thinking about surveillance.

The Fund has explored a number of ideas to strengthen the surveillance framework. One of the most promising is to establish a process with more frequent, published staff assessments of performance against a medium-term framework designed by the member country. That assessment could convey a

clear judgement about the degree of progress being made in reducing vulnerabilities, improving resilience, and strengthening the structural underpinnings of growth. Analysis of public and external debt trends, benchmarked against sustainability and vulnerability thresholds, and stress tests for relevant shocks could play a key role in this process.

There are compelling arguments for combining such a framework with contingent access to Fund resources. Surveillance today does not provide a meaningful check on ex ante policies, and resources are only made available when the financial need is acute. Access to supplemental resources from the Fund on a precautionary or contingent basis could make a critical difference in preventing short-term liquidity crises from becoming full-scale solvency problems leading to default. Of course, access to such contingent financing should be limited to countries whose policies were judged reasonably sustainable, and consistent with a reduction in balance sheet risks over time. With an enhanced surveillance framework designed to help keep policy on a stronger path that does reduce risk over time, and with contingent finance that could be mobilized quickly, the Fund would be better positioned to contain the risk of deeper financial crisis. And more of the policy reform that is a necessary accompaniment to Fund finance resources could be supported ex ante, rather than ex post. Catalyzing better policies sooner is the best defense, though it will never be a perfect defense, against crises.

Facilitating restructurings

We have seen some progress in the last few years in efforts to improve the framework for sovereign restructurings. In particular, collective action clauses have now become the market standard where emerging market governments issue debt under foreign law. It will take some time for the full stock of sovereign emerging market debt to include these provisions for restructuring by majority action, but this progress is nonetheless important.

But there are also some experiences that overshadow these more encouraging developments, and expose a breakdown in the broad consensus that had formed the basis for the successful past strategies of collaboration among the official sector, borrowers, and private creditors.

Without commenting on the specifics of any particular case, let me offer a view of what I see as fundamental tenets of a credible approach by the international community to situations where a sovereign finds it necessary to restructure its obligations to private creditors:

The IMF should be willing to lend to a sovereign that is in default to its private creditors only when two conditions have been established:

First, the country must commit to a credible medium-term adjustment program, one that offers the prospect of a successful restructuring and a reasonably early return to the capital markets. This has to be established up front for any restructuring effort to work. Commitment to a credible adjustment path that offers the reasonable prospect of a return to financial viability and growth is the necessary foundation for engagement by the creditors in a restructuring process. Without that, there is little basis for meaningful engagement. The science of economics does not provide a definitive answer to what that adjustment path must be, but it does offer the means to determine a reasonable band of outcomes between the inadequate and the excessive. This judgment must be made by the government. It can be informed by consultations with the creditors. Ultimately, though, it has to be endorsed by the Fund, if the Fund is to lend.

Second, before the Fund can commit its support, the country must develop, in consultation with its advisors, and outline to the Fund and its creditors, a credible and monitorable framework for cooperatively achieving a viable debt restructuring, one that leaves the country with a sustainable debt burden. The issues of appropriate adjustment and appropriate broad terms of proposed restructuring are closely intertwined and need to be assessed in tandem. For the Fund, it should be an essential prerequisite that the country demonstrate at the outset that its approach has credible prospects for enlisting broad creditor concurrence, and for being consistent with the country’s macroeconomic framework and payment prospects.

Reaffirming these conditions as the foundation for Fund support in restructuring or arrears cases would be a useful contribution to the system, and would leave the Fund better positioned to contribute to the favorable resolution of future crises that involve restructurings.

Strengthening the Fund's financial instruments

The Fund has taken a number of important steps to make its financial instruments more effective for dealing with the challenges inherent in a world with ever more integrated national financial systems. The reforms of late 90's - the increase in the size of the Fund and its supplemental borrowing arrangements, the launch of new facilities that offered the means for large-scale lending at penalty rates in carefully circumscribed cases, the introduction of greater flexibility in the phasing of resources, and in how those resources could be used to reestablish confidence - were extremely important. More recently the Fund adopted a set of criteria designed to limit the risk that the Fund would make large-scale resources available too frequently and in conditions where they would be unlikely to contribute to a resolution of the crisis. These various reforms gave the Fund a substantially more effective insurance mechanism for emerging market economies than it had before.

Building on this progress, I see the key elements of a credible insurance mechanism as including the following:

- Finance must be conditioned on a policy framework strong enough and timely enough to restore confidence. Fund resources can't compensate for a lack of policy credibility, and lending official resources to fund an inadequate policy effort may make the situation worse.
- The scale of finance provided has to be calibrated to the need, and the needs can be substantial in today's world. The Fund can only fill part of the gap, but it has to be able to fill a credible share of the gap if it is to play a successful part in catalyzing other resources to flow.
- Flexibility to structure programs appropriate to the circumstances and the borrower's policy efforts is essential. The Fund needs to be able to substantially front-load financial packages, when this is warranted. Making available small tranches of resources over the life of a program does little to address the realities of open emerging market economies facing liquidity problems. Rather than the classic staircase pattern of disbursements, the Fund should consider, in some cases, providing a larger up front tranche that floats and is available if stress materializes and policy is responding appropriately.
- The Fund should stand ready to support countries in pursuing reasonable restructuring proposals when warranted by the circumstances. Official financial resources in that context can be helpful in meeting some targeted needs.
- And finally, the Fund needs a more credible capacity to withstand arrears, so that it does not face the reality or the perception that is can be induced to accept weak programs only to allow it to refinance its exposure.

Conclusion

These are modest proposals. They only cover a small piece of the world of the Fund, much less the broader Bretton Woods institutions. They would not fundamentally change the balance established by the Fund's articles between the rights and obligations of its members. But they would help position the Fund to deal with future financial pressure in emerging markets. And given the scale of the economic costs imposed by recent crises, that is an important goal.

Thank you.