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International financial institutions in the world economy

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In the last five years the benefits deriving from the opening up of markets and the elimination of barriers to trade and to the international mobility of productive factors have become progressively greater. The world economy has expanded, per capita incomes have risen, inflation has settled to historically low levels, and the financial markets have been marked by abundant liquidity, low interest rates and limited asset-price volatility.

In the first half of 2006 the world economy continued to grow at a fast pace; indeed, its further acceleration took the main public and private research institutes somewhat by surprise, prompting them to revise up their forecasts for the two years 2006-07, except for the United States. According to the International Monetary Fund's current estimates, which are in line with those of other international organizations and private institutes, world GDP growth will be 5.1 per cent in 2006 and then decelerate slightly to 4.9 per cent in 2007. These are remarkable figures by historical standards; if the forecasts are borne out, the four years 2004-07 will be the period of greatest global expansion since the early 1970s.

On the whole growth is becoming more evenly balanced among the different regions of the world: the slowing of the American economy is accompanied by a more vigorous recovery in the euro area and the continuation of growth in Japan and the main emerging countries, especially China and India.

Global inflation was reduced by more than half in the second part of the 1990s and continued to decline in the subsequent years, falling to 3.8 per cent in 2006. The combination in recent years of high growth and low inflation is the product of numerous factors, starting with the quality and credibility of monetary policy. In turn the action of the central banks has been facilitated by globalization. In particular, the far-reaching transformation of China's economy and the entry of that country into the world trading system have helped to moderate inflation by stimulating productivity gains in the advanced countries exposed to Chinese competition and by holding down the rates of increase in the prices of imported manufactures and in wages.

On the financial markets, volatility has been much lower in the past few years than in the 1990s. The current phase is distinguished in particular by the simultaneous involvement of different instruments and markets, embracing equities, government and corporate bonds, short-term interest rates and exchange rates, and extending to both the industrialized and the emerging economies. The reduction in volatility is largely ascribable to structural developments in the financial markets. The increase in the share of assets managed by professionals such as institutional investors and hedge funds has increased their liquidity, while the rapid growth of the markets for the transfer of risk has allowed investors to cover their exposures and to allocate risks in a way that is probably more efficient than in the past. The quality of monetary policy has also made a positive contribution. Central banks today formulate their objectives more clearly and transparently, communicate them to the public more efficiently and implement monetary policy decisions with greater gradualness; these major changes have been rewarded by a stabilization of expectations regarding inflation and short-term interest rates, with positive effects on longer maturities as well.

However, this favourable scenario is not without risks: pronounced balance-of-payments disequilibria, high crude oil prices, signs of inflationary pressures in the advanced countries, the risk of an inversion of the benign conditions now prevailing on the international financial markets.

The current account deficit of the United States has continued to expand and is set to exceed $800 billion this year; it could rise further in the coming months. The deficit has been accompanied by a further widening of the surplus of the major Asian countries and the formation of huge surpluses in the oil-exporting countries. The existence of pronounced current account imbalances does not necessarily imply a threat to the stability of the international economic and financial system. Deep, liquid and interconnected markets like today's can easily permit these imbalances to be financed. The crucial problem is to understand whether the current trends are sustainable and whether the adjustment will take place in an orderly fashion. The studies and explanations presented to date help us to understand the origin and persistence of these imbalances but do not demonstrate that they can last forever. According to IMF estimates, the continuation of a US deficit at the present levels, equal to 2 per cent of world GDP, would imply a further increase in the share of world financial portfolios invested in US instruments. Until some time ago, the deficit was financed by building up external liabilities represented by direct investment and equity portfolio flows. More recently, purchases of debt securities have increased sharply; a significant role has been played by the investment in US securities of the reserve assets accumulated by the countries running a surplus. The factor income account of the US balance of payments, traditionally in surplus, changed sign for the first time this year. Although the most likely scenario remains a gradual correction of these imbalances, this assumes that international investors will be willing to continue to increase the share of US assets in their portfolios in the years to come. Otherwise, the correction would be more abrupt, with severe repercussions on the exchange rate of the dollar, interest rates and, ultimately, the growth of the world economy. The scale of the potential adjustment costs underlines the need for all the major actors of the world economy to take part in the effort to reduce current account imbalances. I shall return to this point in the final part of this talk, in connection with the role of the IMF.

Since the beginning of the year the price of crude oil rose to a peak of more than $75 a barrel in August before falling sharply to around $60 the following month. The rise was not caused by a cutback in supply, which has in fact increased by 9 per cent in the past three years despite temporary reductions in extraction and refining as a result of hurricane Katrina and the geopolitical disturbances in the Middle East. Rather, the price increase has mainly been due to demand factors, notably the growing energy requirements associated with the rapid expansion of the global economy in recent years, especially in China and the other Asian countries. At a time of low margins of idle capacity and with no prospects of a substantial structural reduction in user countries’ oil dependency, there are no grounds for supposing that the situation will change in the short or medium term.

The rise in oil prices entails a transfer of purchasing power from user to producer countries. For the latter, it is important to exploit the improved terms of trade not only to enlarge the oil industry's productive capacity, but also to diversify the structure of supply. Using the increased revenues to raise national levels of consumption and investment, instead of merely recycling them through financial investments in the advanced countries, would help to mitigate the overall current account disequilibria. In the oil-importing countries, where unaccommodating monetary policies are geared to preventing secondary inflationary effects, real wages and producer prices need to remain suitably flexible if an increase in unemployment is to be avoided and the loss of output contained. On the other hand, the rise in the price of oil has caused a change in relative prices that should bring about a reduction in oil consumption and the use of alternative sources of energy. National governments should not discourage such a process.

One important question is whether the present low volatility will reinforce or undermine financial stability. There is no one answer in this respect. On the one hand the factors mentioned earlier have undoubtedly improved the structure and operation of the markets, while on the other the limited volatility, combined as it is with exceptionally low interest rates, has prompted many investors to seek higher returns, which may have led them to take excessive risks. Another type of danger comes from the very sophistication of the markets: financial derivatives are likely to amplify the effect of disturbances in periods of stress, when market liquidity diminishes; similarly, hedge funds (although helping to increase market liquidity) are likely to accentuate the variability of asset prices. Finally, in a long-term perspective there remains the problem of deciding whether the reduction in volatility is a permanent phenomenon or not. Even if it were permanent, there are doubts whether investors would be able to cope with large and persistent disturbances, which cannot be ruled out a priori. If investors' portfolio choices are based on market prices, which in turn incorporate the expectation of low volatility, these could be affected by sudden shifts in such expectations. To conclude, there is profound uncertainty about the nature of today's financial volatility.

In view of the seriousness of the international payments imbalances and the enormous cost of adjustment, the international financial institutions provide the natural fora in which to exchange information and initiate action.

The objectives, levels and methods of international economic cooperation have been profoundly influenced by the development of closely integrated private financial markets. The scope of cooperation has broadened, spreading from the traditional field of macroeconomics and coordinated economic policies to the sphere of market structure, regulation, supervisory practices, standards and rules of conduct. The number of organizations and agencies dedicated to cooperation has increased, reflecting the need for a more efficient division of labour and variously involving features and elements proper to the private sector.

Since its creation in 1944 the International Monetary Fund has enlarged its membership from the original 40 countries to the present 184, thereby becoming the world's largest multilateral financial institution. Its traditional functions (of “surveillance”, lending and technical assistance) have undergone significant changes. The IMF’s financial function remains hinged on its original structure as a “credit cooperative”. Basically, the capital paid in by the member countries (their “quotas”) is used to grant loans to members with temporary balance-of-payments difficulties. Over the years, the stock of IMF loans to members has fluctuated widely around a trend that was rising until the beginning of the present decade. Peaks in disbursements bear witness to the crises that overtook various categories of member countries, their gravity increasing with the mobility of capital movements: first were the industrial countries, hit by the rise in oil prices of the 1970s; then came the emerging economies, which experienced foreign debt crises in the 1980s and, above all, disturbances to capital movements in the 1990s.

“Surveillance” has undergone more radical changes. Until the 1970s the Fund had been the “guardian” of an international monetary system featuring fixed but adjustable exchange rates and relatively minor movements of capital. In that framework, surveillance was intended to identify economic policies that were consistent with the foreign exchange system and oversee the policies actually followed by the members, with quite broad powers of sanction in the event of failure to meet targets. After the collapse of the fixed-exchange-rate system, the Fund allowed member countries to choose what they considered the most appropriate exchange rate regime, retaining such generic obligations as “stability oriented” domestic policies and the undertaking not to “manipulate” the exchange rate to the disadvantage of trading partners. Notwithstanding these fairly weak legal foundations, the

IMF succeeded in adapting its surveillance activity to the circumstances of the members and exerted substantial influence on their economic policies, especially in the emerging countries. In the light of the financial crises of the late 1990s and the heightened attention to the financial sector of the economy, surveillance was extended beyond the traditional area of macroeconomic policy to bear on the adoption of and compliance with standards and codes of conduct in banking supervision, market rules, and transparency of statistics.

Today the Fund is grappling with an identity crisis, rooted in the sharp fall in the last three years in its traditional clients' demand for credit. The stock of IMF loans has fallen to the level of the early 1980s. Paradoxically, this reflects a positive development, namely the robust health of the world economy and the absence of financial crises. In the last few years the emerging countries have built up foreign exchange reserves that now outweigh the funds of the IMF tenfold. There have been proposals, notably by the Asian countries, to use a part of these reserves to institute new "regional monetary funds" to provide loans in a similar way to the IMF.

If this reduction in the amount of credit granted were to prove permanent, there would be no alternative to drastically scaling back the Fund's financial function. "Surveillance" itself would have to be reformed, since the IMF's influence over member countries derives in part from its role as potential supplier of finance.

The diminution in the Fund's lending is the result of both structural and cyclical factors. The structural factors include the prevalence of flexible exchange rate regimes, the improved quality of members' economic policies and the ability of the private financial markets to satisfy the demand for credit. However, an end to the present positive phase cannot be ruled out. Sudden changes in exchange rates and interest rates or jumps in risk premiums could complicate the debt position of some of the emerging economies.

It is thus not a question of removing the Fund from the roster of international financial institutions or reducing its role, but rather of making it better suited to the conditions of a complex, globalized economy.

There must be fundamental reform in two areas: the Fund's "mission" and its governance structure. The "surveillance" function has returned to being the fulcrum of IMF activity, especially as regards: (a) the exchange rates between the main economies, both advanced and emerging; and (b) the urgent need to curb balance-of-payments imbalances. On the latter front, the Fund recently began consultations with policy makers in the United States, Japan, the euro area, China and Saudi Arabia. The aim is to design measures to reduce the imbalances and work for their adoption, through internationally concerted efforts.

As to the governance of the IMF, there is a perceived need to bring voting and decision-making power within the Fund more closely into line with the changed economic importance of the various member countries. In this year's annual meetings in Singapore it was agreed to increase the quotas, and with them the voting rights, of the most seriously underrepresented countries: China, South Korea, Mexico and Turkey. It is expected that in the future other emerging countries will have their quotas and voting rights increased. The voice of the poorest countries in directing the affairs of the Fund will be safeguarded.

The Financial Stability Forum (FSF), set up in 1999 at the initiative of the G7, provides a venue for informal discussion among the governments, central banks and national supervisory authorities responsible for financial stability of the seven leading countries, Australia, the Netherlands, Hong Kong and Singapore. In addition, meetings are attended by representatives of the international financial institutions (the IMF, the World Bank, the BIS and the OECD) and self-regulatory bodies in the banking, corporate, insurance and accounting fields.

The Forum’s mandate is: a) to assess vulnerabilities affecting the international financial system; b) to identify and oversee action needed to address these; and c) to improve coordination and information exchange among the various authorities responsible for financial stability.

Among the potential sources of vulnerability, the Forum has addressed the issues of the role of off-shore financial centres, the operation of highly-leveraged financial institutions, the volume and variability of capital flows, the transfer of credit risk, reinsurance companies, corporate governance rules and, more recently, the activity of hedge funds. The Forum has also encouraged the adoption of standards and codes of conduct established at international level. As a general principle, the attention of the Forum is focused on the intermediaries and infrastructure of the financial sector rather than on individual countries and on structural, financial and regulatory problems rather than those of a cyclical, real or macroeconomic nature. Its ultimate aim is to prevent crises, not to forecast or manage them.

Looking ahead, one cause for concern is the danger of the present period of low volatility in the markets coming to an end without financial institutions being adequately prepared. This is all the more likely at a time of transition such as the present: it is becoming increasingly difficult to incorporate the flow of financial innovations into complex risk management systems. It is therefore important for regulators to possess accurate and up-to-date information on the size and distribution of risks, the nature of the investors holding them, the structure and liquidity of markets, and the functioning of new financial products. In order to ensure that financial institutions have a better understanding of the new risks and are equipped to manage them efficiently, it is also necessary to verify the solidity of their internal control mechanisms and improve the collection of statistical information. This process entails costs, which could be considered excessive if problems proved to be episodic and on a limited scale. The FSF can make a decisive contribution to assessing the costs and benefits in close cooperation with the private sector.

The acceleration of world economic growth in the last few years is part of a longer-term trend. The introduction of market mechanisms and the opening to international trade have driven the development of large countries: first Japan, South Korea and the Asian tigers; more recently, China and India. They have raised hundreds of millions of people, a significant share of mankind, from conditions of absolute poverty.

For the process to continue, it is important that the opening to market mechanisms and international trade spread from the production and exchange of goods to those of services. Financial services offer an extraordinary potential for growth, with benefits for emerging countries that can hardly be overrated.

The tumultuous growth of these countries requires a modern financial system that can channel their enormous savings and promote an efficient allocation of capital while raising the consumption of households and allowing them to make better provision for the future in the absence of effective social security cover.

The creation of an appropriate institutional framework is a necessary condition for the development of modern financial systems. One of the lessons of the successes of globalization (and also of the failures, which have not been lacking, especially in Sub-Saharan Africa) is the role of good institutions: ensuring legal certainty, efficient justice and honest and effective administration is essential for the development of the economy in general. It is especially important for the financial sector, which cannot prosper without the support of fixed and accepted rules, appropriate standards of corporate behaviour, and sufficiently transparent and efficient markets.

Ensuring the existence of these conditions is not an easy task. It is not only a question of good laws but also, and perhaps above all, of their being applied fully. In many emerging countries it requires a sea change in the culture of administration and in that of economic agents as well. The role played by the governments of these countries is therefore important, but so is that of the international financial institutions, in persuading, assisting and guiding through their example.