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STRENGTHENING THE WORLD FINANCIAL SYSTEM

Let me discuss some topics that are much debated in international fora :

- the main issues as regards the strengthening of emerging markets' financial systems, notably, the implementation of Standards and Codes, transparency and liquidity management
- the ways to cope with financial crises, in particular private sector involvement and the reform of the international governance.

The Eurosystem reached a common view on the reform of the architecture of the international financial system. On most issues, for instance financial systems strengthening, liquidity management, the international governance, the Eurosystem's views converge with those expressed in international fora, in particular the G7, the International Monetary and Financial Committee and the Financial Stability Forum.

I. Strengthening Emerging Markets' Financial Systems and Enhancing the Functioning of International Financial Markets

Three topics are particularly relevant:

- The implementation of Codes and Standards
- Transparency
- Improved reserve and liability management.

The implementation of internationally recognised Codes and Standards will reduce emerging market economies' financial vulnerabilities and together with enhanced transparency, improve market discipline and market participants ability to better assess the risks of their investment decisions. An improved reserve and liability management along the lines recommended by the recent report of the FSF Working Group on Short term capital Flows will provide a "self-insurance" against financial crises.

I.1. Implementation of Internationally recognised Standards and Codes

Three issues should be addressed:

- The need to prioritise the Codes and Standards to be implemented

- The incentives to implement Standards and codes
- The role of the IMF and standard-setting bodies

a. The prioritisation of Standards and Codes

As stressed in the recent report of the Financial Stability Reform Task Force on Implementation, given limited available resources, there is a need to prioritise the key standards for implementation taking into account country circumstances. The FSF Task Force identified 12 of such Codes and Standards out of 65.

The main pillar of this set of Standards are the Core Principles for Effective Banking Supervision, developed under the aegis of the Basel Committee on Banking Supervision, which define the basic conditions for a supervisory system to be effective. In the context of countries having access to international markets, Standards relating to the management of risks associated with cross-border capital flows (e.g. liquidity risk, foreign exchange exposure) are a crucial issue.

b. The Incentives to implement Codes and Standards

We distinguish market and official incentives.

The commitment of economies to implement Codes and Standards will be reinforced if market participants reflect information on observance of Codes and Standards in differentiated credit ratings: market incentives would be enhanced by:

- Disclosure of information on assessment of progress in implementing standards (the Report on Observance of Codes and Standards-ROSC)

- improved understanding by market participants of international standards

Official incentives provided by the international community: one option would be the provision of technical assistance; another option to be considered could be the extension of implementation of Codes and Standards as criteria allowing the access to IMF or International Financial Institutions' resources (as is already the case for the Contingent Credit line)

c. The role of the IMF

The IMF should play a central role in the following areas:

- Co-operation between the standard-setting bodies, especially in designing methodologies for assessing observance of their respective Codes and Standards as has already been done for the Core Principles by the Core Principles Liaison Group

- Identification, through the joint IMF/World Bank Financial Sector Assessment Report, of structural financial vulnerabilities which should help determine which codes should be implemented first

- Assessment of observance of Codes and Standards in co-operation with the standard-setting bodies that are able to devote resources to the assessment of their Codes and Standards

I.2. Transparency

Ensuring more stable capital flows to emerging markets hinges on efficient international capital markets, which in turn depend on the availability of reliable and timely information both on debtor countries and market participants.

Initiatives launched by the international community to enhance transparency in assessing economic and market developments should be supported. While recognising the role of the public sector in leading by example, parallel efforts to enhance transparency of private sector market participants should be pursued whenever relevant. Progress may take the form of improved disclosure on a voluntary basis, more demanding statistical reporting or extended requirements for non-transparent segments of the financial markets, paying due regard to cost/benefit considerations. Specifically:

- the disclosure policy adopted by the IMF (including the pilot project for publication of Article IV reports) and the publication of information on the observance of transparency and good practice standards in key areas are important elements in enabling market participants to make a better-informed risk assessment of potential debtors.

- Countries should endeavour to enhance the transparency of international capital markets, both in the interest of debtor countries and market participants themselves, when market activities fall under their regulatory responsibilities. Thus, the ongoing work being carried out under the aegis of the BIS, the Basel Committee on Banking Supervision, the FSF and IOSCO to improve the availability, quality and coverage of statistical data on financial institutions and to strengthen prudential supervision of financial entities with exposure to highly leveraged institutions should be supported.

I.3. Improved Reserve and Liability Management

Irrespective to the exchange rate regime and maturity profile of the public sector liabilities, debtor countries may have to maintain a relatively high level of external reserves as a buffer against external reserves exceed the sovereign external debt falling due in the coming year (the "Guidotti rule"). The international community may assist in developing best practices related to reserve and debt management:

- Foreign exchanges reserves should be managed taking into account both the nature of the exchange rate regime and the potential drains on reserves, in particular those linked to short-term external debt. In this context, the more stringent publication obligations on net foreign exchange reserves with one-month frequency and a one-month time-lag, adopted by the IMF within the context of the Special Data Dissemination Standard (SDDS) are welcome;

- The IMF and the World Bank initiative to promote good practices in reserve and sovereign liability management, in particular careful management of the debt maturity profile, should be encouraged. I would like to stress that assessing the liquidity risk and foreign exposure of the economy as a whole requires adequate balance sheet information from both the public and the private financial and corporate sectors.

II. Crisis Prevention and Management

I will focus on two much debated issues: the private sector's involvement and the role of the international governance, in particular the role of the IMF.

II.1. Private Sector Involvement

If we look at what has been done so far in this area, we observe that progress has been mainly made on the "less co-operative" end of the spectrum of proposals that have been put forward for private sector involvement: for instance the decision by the IMF to extend its "policy of lending into arrears" which allows the IMF to informally sanction, in certain circumstances, debt service payments suspension.

More efforts should be devoted to the promotion of approaches that overcome creditors' co-ordination problems. In particular:

- in normal times, lenders and borrowers should seek to establish regular channels of communication;
- countries should be encouraged to contract private contingent credit lines
- the introduction of Collective Action Clauses in bond contracts should become a market standard.

In times of crisis, borrowers should be encouraged to open negotiations with all classes of creditors , seeking co-operative solutions while respecting comparability of treatment among creditors.

While the involvement of the private sector in crisis resolution should be considered as an *a priori* rule in order to minimise moral hazard, I believe that flexibility is needed to address diverse cases within the framework of principles and tools adopted by the G7 at the Köln Summit in June 1999. In particular, a case by case approach is needed to determine the form of the private sector involvement (for instance, roll over or need for debt restructuring).

II.2. International Governance

Let me stress two recent significant improvements of the governance of the international monetary and financial system:

- The creation of the Financial Stability Forum

- The reform of the IMF which is in process

The creation of the FSF in February 1999, aimed at:

- identifying structural financial vulnerabilities in the international financial system
- making proposals to address these vulnerabilities
- improving co-ordination between national authorities and international groupings and financial institutions involved in financial stability *issues [in order to facilitate the implementation of these proposals]*.

The work already done by the FSF covers three important areas: measures enhancing transparency of highly leveraged institutions, proposals making short term capital flows more stable and recommendations of measures enhancing off shore centres' observance of international standards.

As regards the process of the reform of the IMF, a clear division of labour with the World Bank should be maintained. In particular, the IMF should primarily focus on macro-economic and macro-financial stability, while the World Bank should focus on project financing.

This implies that the IMF should cover structural matters as they have a bearing on macro-economic and financial stability. The IMF should especially be concerned with financial sector restructuring when structural weaknesses threaten financial stability.

This means that medium term financial instruments designed to finance policies aiming at removing structural distortions should be maintained within the IMF.

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To conclude, I would like to stress four points:

-Firstly, we should avoid the mushrooming of institutions that are making up the financial architecture. We have created, during the last months, the Financial Stability Forum and the informal GXX grouping. We have improved the concept of the Interim Committee of the IMF in transforming it in an International Monetary and Financial Committee which has recently proved to be efficient and creative. Let us now work actively and as professionally as possible within the present framework which, in my opinion, is well designed and promising.

-Secondly, we should now concentrate all our efforts on implementation: Implementation is the key word at present times. We have set up 65 codes of good practices, codes of good conduct. Applying these codes not only in the industrialised economies but also in all economies of the world, including emerging economics and economies in transition is an immense, challenging and urgent endeavour.

-Thirdly, as regards the private sector involvement, I will recommend being as pragmatic and as consistent as possible. Pragmatic because a case by case assessment is always needed and there is, in my opinion, no mechanistic "a priori" approach which would be advisable. Consistent, meaning that once the assessment is made by the International community on the concept of the participation of the private sector in the crisis solution, we have to stick to it and remain absolutely steady. The worst behaviour is for the country concerned and for the international community to change its position vis à vis the private sector during the course of the negotiation.

- And fourthly, I will draw our attention to one of the most important challenges we have to face up with the present state of global finance: the "herd instinct" of market participants. In certain cases the herd behaviour can amplify considerably volatility, create or augment misalignments and induce large-scale global contagion in case of local crisis.

The herd instinct is probably part of the human nature. It is also probably profoundly enshrined in the functioning of the marketplace. This is precisely the reason why we must be particularly eager to minimise its effects. I call for a general review of all our rules, regulations, codes, etc. within that perspective. I have three provisional conclusions in this respect:

- Perhaps we should have a second look at the very rapid generalisation of day to day mark to market accountings. Perhaps a better medium term functioning of the market would call for a clear distinction between various market participants depending on their own time horizons. I do not suggest at all that it could be a miracle solution to avoid herd behaviour. But it seems to me that it deserves some attention from the international community.
- It seems to me that it would also be important to reflect upon the consequences of the very rapid increase of mutual funds in some major markets. All the managers of these funds have to prove permanently on a very short-term basis that they are better managed than the average. This creates a very powerful potential herd instinct.
- Finally, I profoundly think that full transparency is the most efficient tool to counter the setting up of a "herd" and to cope with potential "herd" behaviour. When one knows all about a particular "signature" or about a particular country, there is much less reason to embark into blind crisis contagion... Here is the motto I would like to be accepted globally by market participants: "Let us judge the quality and creditworthiness of any particular signature upon its own peculiar fundamentals, upon its own, particular, assets and liabilities".

Lastly, if you permit me, Mr Chairman, I would like to mention the Euro. Three sentences.

The Euro exchange rates are clearly misaligned in reference to the Euro area fundamentals – robust domestic growth, steady implementation of the single market, affluent domestic savings, healthy external accounts. The Euro system - which is the guardian of the Euro for the sake of the people of Europe - knows that our fellow citizens want the single currency to be at least as solid as were their previous national currencies: in France, to give only one example, 96% of the people are calling for the Euro to be at least as solid as the Franc; needless to say that it is the same in Germany and in all other countries of the Monetary Union. I am profoundly convinced that market participants will realise rapidly, with our help, that the present rates are out of line with fundamentals, and that therefore the potential for appreciation for our currency will rapidly materialise.