MAINTAINING FINANCIAL STABILITY IN A GLOBAL ECONOMY: IS THERE A ROLE FOR THE OECD?

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I. Introduction: the Volatility of Financial Markets

1. The recent instability of global financial markets has resulted in widespread concerns about an impending world crisis, and has prompted considerable debate about the causes of volatility and the possible solutions. BIAC is pleased to present its analysis of the current situation and its suggestions on what the OECD can do to restore confidence and stability in the international financial system.

2. BIAC believes that liberalised capital flows are essential for promoting investment, growth and employment in all economies. However, it must be recognised that global capital markets are inherently unstable. Although they may not be subject to large-scale, especially downward, changes every day, it is nearly inevitable that such movements will occur from time to time. We believe that this risk needs to be better factored into public policy, as well as company strategy.

3. So far much of the recent public policy discussion on the financial crisis and the search for its cause has focused on volatility and the possible "quick-fix" mechanisms for limiting it. Unfortunately, many of the proposed solutions fail to address the reasons behind the large-scale withdrawal of investment from an entire category of countries.

Financial contagion

4. Many experts argue that a large-scale breakdown of confidence in world financial markets has negative effects on economies with sound fundamentals, and that limiting the spread of volatility should thus be considered a primary objective. A general worsening of economic conditions in a large number of countries can often force investors to reassess their willingness to lend in other areas, without a change in the latter's intrinsic conditions. This can be the result of lenders deciding to reduce their exposure in markets with relatively better fundamentals because of the risk of macroeconomic contraction due to declining trade/investment flows between the countries concerned. However, the recent volatility in many countries is better characterised by the "demonstration effect", in that investors have felt compelled "to withdraw their capital from countries with the same problems as were present in the first such country."[1]

5. BIAC believes that two things are simultaneously true about the contagion aspects of the crisis. First, it is clear that the onset of the crisis in Southeast Asia involved some economies with

[1] From Michael Bordo, "International Rescues Versus Bailouts: An Historical Perspective", Cato Institute Monetary Conference speech, 22 October 1998, pp. 7-9 available on www.cato.org/events/monetary.html.

comparatively sound "fundamentals" (measured in terms of government finances or the balance of payments), although current account deficits were recognised to be high in some (e.g., Thailand and Malaysia) in the run up to July 1997[2]. Second, it is equally true that the subsequent withdrawal of funds from emerging markets in general as well as the present perception of global risk arises from the vulnerability of a host of economies with much weaker fundamentals (e.g., Russia). The latter category, which forms the majority of emerging markets, does not consist of "innocent bystanders", but rather economies that have been putting off necessary reforms for too long. Of these two aspects, the first currently attracts the better part of international policy attention – namely, how to protect economies with relatively sound fundamentals from sudden, financially induced instability. However, most BIAC members believe that the basic question of how to generate convergence towards sound macroeconomic policies among all major economies, including the emerging ones, is at least as important as questions of international financial architecture and supervision of financial flows and stocks at the country or international level..

6. Nevertheless, one lesson learned from the recent crisis is clearly that exposure of an economy to short-term foreign currency capital inflows, before its financial system is sufficiently developed to handle a large unanticipated withdrawal, is a highly risky venture. This demonstrates that economies cannot enjoy the advantages of a sophisticated international financial system without the internal discipline that enables such economies to adjust to changing circumstances without crisis. Areas crucial to increased discipline include appropriate bankruptcy and workout procedures for defaulting private sector entities, new arrangements for risk sharing between debtors and creditors, and ways to limit explicit and implicit government guarantees of private debt.

7. We believe there have been many fundamental changes during the last ten or fifteen years in the international system which have improved both the prospects and hope of the poorer countries to develop in a mutually-beneficial way and the ability of the richer societies to interact with the former as partners rather than benefactors or peacekeepers. These improvements should remain as *acquis*. However, we would point out that the following conditions exhibited in an economic environment are not mutually compatible:

i. that emerging economies should be able to pursue productivity improvement through trade specialisation;
ii. that private capital should remain free to move to emerging economies, through direct investment and various forms of lending;
iii. that firms should be able to choose freely the exact type of financial vehicle they use for a given lending/borrowing relationship, including the choice between short term and long term investments which is appropriate for the purposes of the business they are conducting;
iv. but, that emerging economies which receive investment should be free to pursue any type of macroeconomic and institutional polices, including policies which base the pursuit of growth and capacity building (exports at the expanse of their fellow emerging competitors) on short-term borrowing.

8. While an increasing number of commentators may be focusing attention on the politically expedient solution of capital controls (i.e., eliminating the third condition), we believe that the response ought to be sought in the area of surveillance of macroeconomic and institutional policies (i.e., constraining the fourth proposition), unless we are prepared to sacrifice the first and second propositions (which are linked by necessity.) Although there may be a need to examine the impact

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[2] Part of the problem was that some countries in Asia initially looked sound because their financial systems lacked transparency so that foreign investors were not able to assess the level of corporate indebtedness until the crisis exposed the weakness . However, this may not completely absolve foreign investors, which were investing in enterprises without having clear information on their indebtedness, from responsibility. After all, lack of transparency itself should be an important factor in investment decision-making.

of certain financial instruments such as hedge funds, recommendations for broad control of short term capital flows would do more harm than good and thus should not be pursued. It is clear that capital controls are certain to distort investment patterns, reduce real rates of growth, encourage corruption and, at the same time, fail to reduce the frequency and probability of economic crises and recessions.

Inadequate surveillance

9. We consider that policy attention should thus focus on what factors obstruct a prudent assessment of the maturity of financial systems and related risks in the first place, especially when such negligence occurs on a large scale for a prolonged period of time. Recently, the Bank for International Settlements (BIS) provided an emphatic acknowledgement of how good economic performance and circumstances may contain the seeds of future problems, with good domestic "fundamentals" leading to spending excesses and attracting less-performing investment.[3] This leads us to conclude that, while it may not constitute a panacea, a permanent mechanism of interaction and peer review between policy makers of significant economies would make a valuable contribution to stability.

10. But, while it is possible to understand that over-optimism can affect markets and, perhaps even more so, policy-makers, we believe it is worth considering why over-optimism can become so pervasive in world financial markets. Private sector credit rating agencies could not have been expected to play the role of whistle-blowers, as these agencies are not designed nor supposed to play a role in global surveillance. Such agencies are unlikely to predict a crisis coming. This is because their projects are likely to be country- or company-specific whereas a crisis is necessarily precipitated by a series of countries or (big) companies (or banks) running into trouble ***simultaneously***. In other words, it is ***the combination of events*** that normally precipitate a large-scale crisis.

II. Addressing the Fundamental Problems

11. This leads us to two interim conclusions. First, it is important to seize upon the "salutary effects" of the crises like this to instil a proper sense of humility in international discussions. In good times, governments and international organisations should not over-emphasise "success stories" and endogenous, systemic developments, such as the rapid growth of private financial flows to developing countries as goods in and of themselves. Public funds could be better used to promote an understanding of how traditional, “old-fashioned” policy challenges and risks will continue to be faced in the "new global age." Second, we believe it is time to reassess the weaknesses of existing mechanisms for dialogue, monitoring and surveillance. In particular, it must be understood that, most probably, the type of organisation that might actually contribute to enhancing stability and strengthening institutions in the developing world are likely to consist of low-key, discrete processes that maintain a long-term focus on issues and provide a venue for trust-based contact between policy makers, rather than anything that might generate headlines in the media.

Transparency of existing institutions

12. Transparency serves a purpose (such as forestalling currency or banking crises) when there are institutions with mandate, capacity and clout to carry out analysis and assessment to be able to give advance warning when fundamentals deteriorate. In turn, analysis can serve a purpose when there is a clear process of surveillance. What then is the best mechanism to carry out surveillance?

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[3] Bank of International Settlements, *68th Annual Report*, Basle, 1998, pp. 162-163.

13. BIAC strongly disagrees with the popular view that we simply need new institutions and regulations at the international level, to make the globalised economy look more like a national one. Because there is no world government, and that there cannot and probably should not be one, littering the world economic landscape with institutions that can only function with sufficient authority and legitimacy behind them will only add to the present confusion. Without clear legitimacy and credibility, attempts to regulate at the world level would very likely be piecemeal and incoherent at best. Notwithstanding the merits of reviewing the current system of international financial surveillance, the debate about creating a new global "lender of last resort" is really not the heart of the problem. The issue remains: how to influence economic policies carried out by seemingly sovereign entities so that the function of lender of last resort does not need to be exercised too often.

III. Revitalising Multilateral Policy Co-operation with New Players

14. If a world-wide financial regulatory authority or other forms of top-down (donor-recipient) surveillance relationships have become even more difficult to exercise today, which they seem to be, what other mechanisms are conceivable? How can sovereign nation states be persuaded to take part in a voluntary but meaningful process of economic performance review that covers not only their financial linkages with the rest of the world but also an evaluation of their "domestic" institutions, macroeconomic policies and trends?

15. It is clear that such a process will need to involve regular interaction, even at times when performance appears good, rather than being ad hoc, because as stated above, success may contain the seeds of future troubles. It is also our view that, given the results of the past four or more development decades, there is now an entire set of economies outside the OECD area which simply cannot be treated as students in development in the hands of donor international financial institutions (IFIs), given the capacities and aspirations of their leadership. To put it differently, any surveillance mechanism for the task now envisaged must treat emerging economies as equals (to advanced OECD economies). We believe that only this, i.e., reciprocity of participation in peer review and surveillance, can generate a sufficient degree of interest and commitment by the leadership of the emerging economies to enable them to participate in a meaningful way. Such a process would give the new players a say in any policy review affecting today's advanced economies as well.

"Outreach" versus mutual surveillance

16. The OECD has been reflecting on its role in the current world with increasing number of national "players", as well as on how to "reach out" to the latter in its activities, for nearly a decade. However, much of the outreach activity to date has taken the form of both ad hoc and top down programmes, mainly conceived as vehicles for diffusing the policy experience gained within OECD economies and the Organisation to the rest of the world. While these interactions are clearly valuable, BIAC believes that the level of policy coherence required between the developed and emerging economies will require a mechanism with a much higher scale and scope of involvement between the economic policy making communities of both sides.

17. Recently there have been several multilateral initiatives to strengthen policy co-ordination. One proposal is to create an ad hoc group of 22 countries – termed the "systematically significant economies" – to work on issues of transparency and strengthening of the IFIs. The latter initiative at present has a clearly defined task of studying policy options regarding the architecture and wiring of IFIs. However, if at some later stage there was felt the need to engage in policy dialogue on broader economic policies and performance, as we believe there should be, that mechanism

would also have to contain these significant economies. The OECD members constitute roughly half of the G-22.

18. While the G-22 model may be perfectly adequate for its present task, it is hard to imagine how any policy dialogue and co-ordination effort among country groups of similar composition – i.e., cutting across the OECD-non-OECD boundary – can be maintained without clear arrangements for an international and neutral secretariat and a clear and transparent process for conducting policy review of its members. Experience with the G-7 model suggests that quasi-informal high-level international mechanisms are not designed to address international questions requiring a long-term focus of governmental departments, except where they can delegate most actual substantive work to other organisations (as they often do to the OECD).

19. How then to create a mechanism which is at the same time:

– not ad hoc, sufficiently regular so that it receives a commitment from both high-level as well as working-level policy-making establishment,

– where all members have equal status and commitment,

– involves small enough a number of countries to enable an effective working relationship among their respective departments and the international secretariat, to work like today's OECD does, and

– and, yet includes all significant economies?

20. Our recommendation is that government representatives should consider using and expanding the existing OECD resources and model to develop an international economic surveillance mechanism which would include regular participation of key economies. In our view, engaging the ***systemically*** significant economies in periodic peer reviews would make an important contribution to multilateral surveillance and transparency by generating greater understanding by policy-makers of macroeconomic conditions and structural policy issues, and by offering a more effective mechanism for policy co-ordination. We understand that some steps have already been taken to invite key non-member economies to certain meetings on economic forecasting, and we support this orientation.

21. Independently of any active role in economic surveillance, OECD might be well situated to improve collection and analysis of statistics and institutional information on financial markets, particularly concerning the emerging markets and the increasingly diverse new types of investment vehicles used (including, for example, hedge funds). OECD's non-binding character and the absence of tensions related to funding might actually enable a more suitable environment to information sharing in these sensitive areas.

What can business contribute?

22. If the OECD ends up assuming a greater role in economic co-ordination with key non-member economies, business would be interested and prepared to participate in a comprehensive, albeit informal way in the surveillance process. BIAC's experience with informal annual contacts with the Economics Department secretariat on economic forecasting has proven to be a valuable dialogue, appreciated because it enables better understanding of the thinking which underlies each other's forecasts. More direct and regular participation of business representatives in EPC and EDRC processes should be considered.

23. Business also stands ready to contribute to a dialogue with governments on the monitoring of capital flows, including their destination and composition, and assessment of potential risks associated with debt/investment stocks. OECD could consider utilising the private sector as a sounding board to check if statistics collected and evaluation carried out in this area are consistent with reality.

A continuing role for best-practice policy promulgation

24. While the view that OECD should be the focus of multilateral surveillance is not necessarily shared by all in the business community, there is broader agreement for an OECD role to provide guidance to other significant economies in the area of structural reform, including taxation, financial systems, and labour policy.

25. More importantly, BIAC believes that there is a need for respectable international economic co-ordination bodies such as the OECD to come out strongly against hasty policy activism aimed at curing the symptoms of the current crisis, such as new regulations to limit short-term capital movements. Before governments rush to implement such "temporary" measures, policy makers should be reminded of the widespread tendency of short-term measures to become permanent. We would urge that governments conduct a thorough evaluation of the costs and benefits of any proposed regulations as recommended in the OECD's Regulatory Reform work.

Multilateral Framework on Investment

26. BIAC considers that the OECD also has an important role in continuing to promulgate high-standard rules throughout the global economy. For example, we believe that the effects of the current crisis could have been mitigated if the Multilateral Agreement on Investment had already been in force. With structures in place that support accountability, transparency and non-discrimination, (a) investor choices can favour enterprises with real competitive advantages, thus promoting economic efficiency and growth, and (b) as a result, investor confidence can be strengthened, reducing the risk of sudden widespread capital flight.

27. An international framework of rules guaranteeing non-discriminatory treatment of foreign direct investment would not have exacerbated the current situation by "giving multinational enterprises greater rights than sovereign governments", but would instead have promoted stability by giving companies the confidence to make long-term, direct investments less prone to capital flight[4]. Direct investment is recognised to be the preferable mode of capital inflow in order to ensure better efficiency of investment, avoid diversion of funds to current consumption, or generate relatively stable and predictable flows of capital, among other things – all factors contributing to stability and confidence[5].

28. BIAC believes there will inevitably be an MAI-type agreement at some point because such an agreement would be an essential component of the international economic system. Many countries outside the OECD area aspire to meet internationally-agreed expectations, as they wish to encourage foreign investors to choose their markets. The OECD has a critical role in helping shape an international consensus of such expectations. We hope that work will continue on this important endeavour, and that the discussion of necessary high standards will include key non-member recipients of foreign direct investment.

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[4] J. Frankel and A. Rose, 1996, "Currency Crashes in Emerging Markets: Empirical Indicators", NBER Working Paper No. 5437, quoted in H. Reisen, 1998, "Domestic causes of Currency Crises: Policy Lessons for Crisis Avoidance", OECD Development Centre Technical Paper No. 136, June.

[5] H. Reisen, 1998, op. cit., p. 27, and work cited therein.

Corporate governance

29. Similarly, BIAC considers that OECD guidance on corporate governance could – provided that it adequately represents the shared views of OECD governments – contribute usefully both to promoting a comprehensive examination of corporate governance practices and promoting confidence of investors in emerging markets where OECD guidance is usefully applied. We hope that the exercise will continue to aim at increasing transparency and accountability of boards and managers to shareholders, especially in so far as it stresses directors' responsibility for risk management and for the viability and solvency of their business. BIAC would expect to participate in full to any review exercise and elaboration of its conclusions, to ensure an adequate reflection of the variety of corporate governance cultures and practices.

Combating bribery

30. The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions is a very important tool for improving transparency, and is strongly supported by business. BIAC believes that its full and speedy implementation both within and outside the OECD membership, combined with strong statements by OECD governments against extortion (an issue not covered by the Convention), could help promote transparent structures and investor confidence.

IV. Conclusion: a Pro-active Role for the OECD requires Commitment

31. BIAC realises that the recommendations in this paper may involve a substantial re-orientation in the OECD's operations and relations with non-Member countries. Moreover, expanding the Organisation's role in averting, or at least promoting better understanding of future financial crises will clearly involve a new commitment by Member countries to provide adequate funding. BIAC considers that these questions must be addressed if the OECD is to make a meaningful, pro-active (and not simply reactive) contribution to restoring confidence and stability in the international financial system.

Questions to Permanent Representatives:

1. ***Would they see a value in a broad expansion of the OECD's economic policy and development review processes, general country and cross-country economic monitoring activities as well as selected committees in the area of international financial relations, to full membership (of the committees, not the Organisation) by emerging economies?***

2. ***If so, would they be prepared to envisage flexible arrangements for these specific committees to enable a system of rotating membership to enable adequate representation of different world regions in a given activity, while the total number of active participants around the table is kept at manageable levels? Would they be prepared to reflect on the merits of a multi-layered architecture for membership and participation in committees?***

3. ***BIAC cites OECD work on structural reforms in taxation, financial systems and labour policy, as well as promulgation of high-standard multilateral rules on investment, corruption and bribery, and corporate governance as important areas for broader involvement on non-member countries. Are there other areas which should be considered in this context?***

4. ***Is there political commitment at the national level for making the OECD an important player in fostering greater investor confidence and financial market stability? If not, how and where should the issue of improved surveillance take place?***