

CENTRAL BANKS AND THE NEW INTERNATIONAL FINANCIAL ARCHITECTURE

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**CENTRAL BANKING IN THE 21ST CENTURY:
IMPLICATIONS OF ECONOMIC
AND FINANCIAL GLOBALIZATION**

**BANK NEGARA MALAYSIA
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1. NATURE AND CAUSES OF THE CURRENT FINANCIAL CRISIS

- INTERNATIONAL FINANCIAL CRISES HAVE BEEN TRADITIONALLY ASSOCIATED WITH EMERGING MARKET ECONOMIES.
- BUT THE CURRENT CRISIS HAS ITS ORIGINS IN ADVANCED COUNTRIES.
- IN ADDITION, THERE ARE MANY ELEMENTS IN COMMON BETWEEN PREVIOUS CRISES IN EMERGING MARKET ECONOMIES AND THE CURRENT ONE.
- THIS IS NOT AS SURPRISING AS IT SEEMS, AS SHOWN BY REINHART AND ROGOFF.

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1. NATURE AND CAUSES OF THE CURRENT FINANCIAL CRISIS

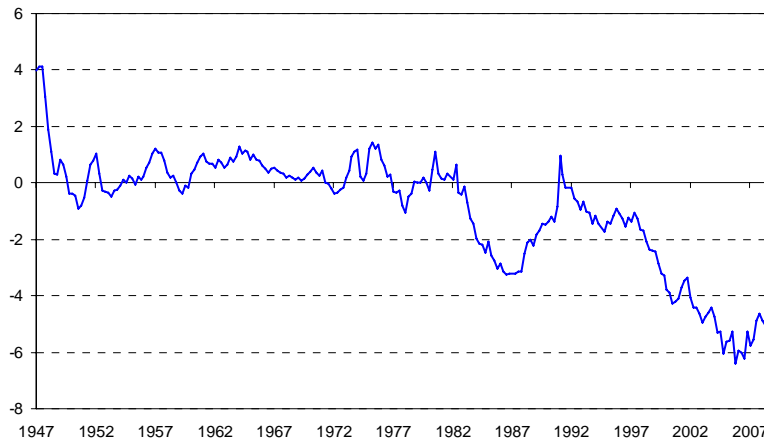
- THE BURSTING OF THE HOUSING BUBBLE IN THE US WAS THE TRIGGER OF THE FINANCIAL CRISIS.
- HOWEVER, THE FUNDAMENTAL FORCES BEHIND THE CRISIS ARE MORE RELATED TO:
 - LARGE AND GROWING GLOBAL IMBALANCES.
 - ABUNDANT LIQUIDITY WORLDWIDE.
 - LOW INTERNATIONAL INTEREST RATES.

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1. NATURE AND CAUSES OF THE CURRENT FINANCIAL CRISIS

US: Current Account
Percent of GDP



Source: Bureau of Economic Analysis.

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1. NATURE AND CAUSES OF THE CURRENT FINANCIAL CRISIS

- HUGE CAPITAL INFLOWS TO FINANCE THE CURRENT ACCOUNT DEFICIT COMBINED WITH OTHER FACTORS LED TO A LENDING BOOM.
- A NUMBER OF VULNERABILITIES EMERGED:
 - SHORTCOMINGS IN RISK MANAGEMENT AND TRANSPARENCY PRACTICES IN FINANCIAL INSTITUTIONS.
 - PERVERSE INCENTIVES.
 - SOPHISTICATED FINANCIAL INSTRUMENTS.
 - HIGH DEGREE OF LEVERAGING.

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1. NATURE AND CAUSES OF THE CURRENT FINANCIAL CRISIS

- THE REQUIRED CORRECTIVE ACTIONS WERE NOT IMPLEMENTED.
 - THE INITIAL DIAGNOSIS WAS NOT PRECISE.
 - BELIEF THAT THE EXISTING FRAMEWORK FOR FINANCIAL SUPERVISION AND MARKET FORCES WOULD BE SUFFICIENT.
 - COMPLACENCY SINCE THE FINANCIAL SYSTEM HAD ADJUSTED RELATIVELY SMOOTHLY TO PREVIOUS SHOCKS.
- THUS, THE RESPONSE WAS BASED ON AD HOC MEASURES NOT ALWAYS CONSISTENT AMONG THEMSELVES.

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1. NATURE AND CAUSES OF THE CURRENT FINANCIAL CRISIS

THE CURRENT FINANCIAL CRISIS IN THE US HAS MANY ELEMENTS IN COMMON WITH SOME EMERGING MARKET CRISES:

- HEFTY MACROECONOMIC IMBALANCES.
- LARGE CAPITAL INFLOWS.
- EXCESSIVE CREDIT GROWTH.
- DEFICIENCIES IN BANKING PRACTICES.
- LACK OF TRANSPARENCY.
- DISTORTED INCENTIVES.
- SHORTCOMINGS IN FINANCIAL REGULATION AND SUPERVISION.
- LIQUIDITY, SOLVENCY AND SYSTEMIC PROBLEMS.

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2. IMPACT ON EMERGING MARKET ECONOMIES

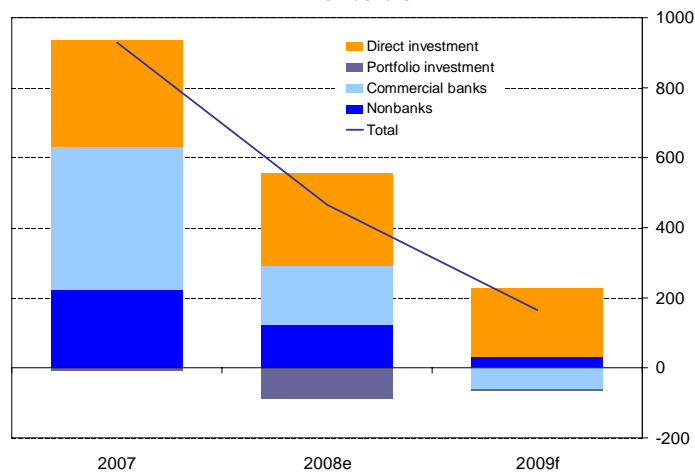
- THEORY OF DECOUPLING FAILED.
- LEHMAN BROTHERS BANKRUPTCY REPRESENTED THE CRUCIAL POINT:
 - UNPRECEDENTED INCREASE IN RISK AVERSION AND A GENERALIZED FLIGHT TO SAFETY.
 - MASSIVE LIQUIDATION OF RISKY ASSETS AND DESTRUCTION OF WEALTH.
 - NON LINEAR PATTERN OF CONTAGION FROM ADVANCED TO EMERGING MARKET ECONOMIES.

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2. IMPACT ON EMERGING MARKET ECONOMIES

Net External Financing to Emerging Economies
Billion dollars



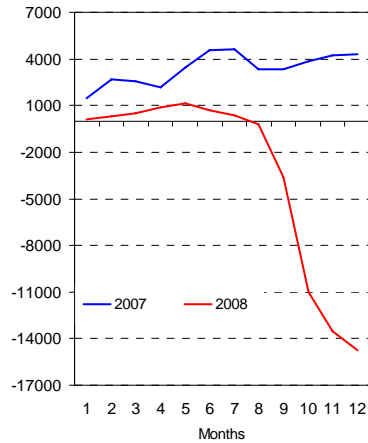
e: Estimated f: Forecast
Source: IIF

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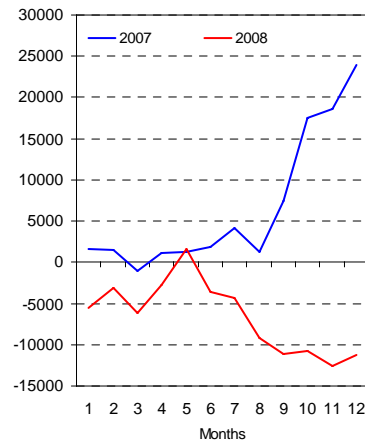
2. IMPACT ON EMERGING MARKET ECONOMIES

Dedicated Flow of Funds to Emerging Economies (Debt)
Millions of dollars



Source: Emerging Portfolio Fund Research.

Dedicated Flow of Funds to Emerging Economies (Equity)
Millions of dollars



Source: Emerging Portfolio Fund Research.

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2. IMPACT ON EMERGING MARKET ECONOMIES

- EMERGING MARKET ECONOMIES ARE UNDERGOING A COMPLICATED ADJUSTMENT TO THIS EPISODE OF FINANCIAL TURMOIL.
- TWO CHANNELS HAVE BEEN AT WORK:
 - REAL SECTOR CHANNEL.
 - FINANCIAL CHANNEL.

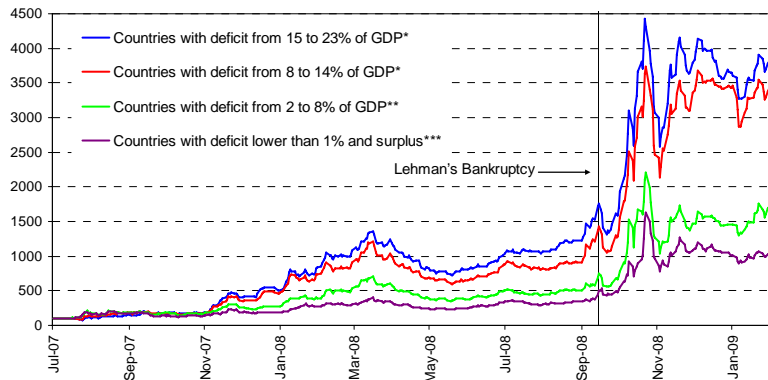
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2. IMPACT ON EMERGING MARKET ECONOMIES

The most affected countries have been those with larger external imbalances, weaker fiscal positions and banking systems with currency mismatches and other flaws.

Sovereign CDS Spreads of Emerging Countries
Index July 02, 2007=100



*Sample of 3 countries. **Sample of 6 countries. ***Sample of 12 Countries.
Source: IMF and Thomson Financial.

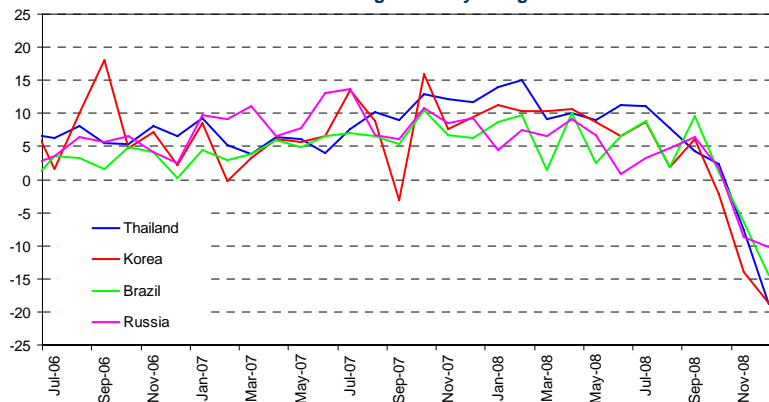
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2. IMPACT ON EMERGING MARKET ECONOMIES

Problems in the financial sector have spread to the real sector with amazing speed and magnitude.

Industrial Production in Selected Emerging Countries
Percent change from a year ago



Source: Bloomberg.

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2. IMPACT ON EMERGING MARKET ECONOMIES

- THE IMPLICATIONS FOR EMERGING MARKET ECONOMIES EXTEND BEYOND THE SHORT RUN.
- THE POTENTIAL RATE OF GROWTH OF THE WORLD ECONOMY MAY HAVE DECLINED.
 - FINANCIAL DELEVERAGING AND THE RESTORATION OF CONFIDENCE WILL TAKE TIME.
 - DIRECTION OF CAPITAL FLOWS IS GIVING RISE TO RESOURCE MISALLOCATION.

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3. CHALLENGES IN REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

- REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE REQUIRES THE SIMULTANEOUS IMPLEMENTATION OF MEASURES IN MANY AREAS.
- G20 HAS CALLED FOR ACTION IN SEVERAL FRONTS.
- FOCUS OF THIS PRESENTATION:
 - INTERNATIONAL COOPERATION.
 - REFORM OF THE IMF.

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3. CHALLENGES IN REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

INTERNATIONAL COOPERATION

- CURRENT EFFORTS OF INTERNATIONAL COOPERATION IN THE CONTEXT OF THE IMF, G20, BIS, ETC. ARE INSUFFICIENT.
- THIS CAN BE ILLUSTRATED BY THE FAILURE OF EFFORTS OF IMF MULTILATERAL CONSULTATIONS.
- HAD CONCRETE RESULTS EMERGED FROM THESE CONSULTATIONS, THE CRISIS COULD HAVE BEEN AVOIDED OR ITS MAGNITUDE REDUCED.

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3. CHALLENGES IN REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

INTERNATIONAL COOPERATION

- RENEWED EFFORTS ARE NEEDED. THIS IMPLIES:
 - STRENGTHENING THE ROLE OF EXISTING FORA.
 - BUILDING AN INTERNATIONAL INFRASTRUCTURE THAT FACILITATES HIGHER LEVELS OF COOPERATION AMONG COUNTRIES IN NORMAL TIMES, TO:
 - PROVIDE A FRAMEWORK TO ANALYZE COORDINATED EFFORTS TO INSURE ECONOMIES AGAINST TRAUMATIC EVENTS.
 - PROVIDE THE INFRASTRUCTURE TO FACILITATE THE IMPLEMENTATION OF COLLECTIVE POLICIES IN PERIODS OF SEVERE FINANCIAL STRESS.

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3. CHALLENGES IN REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

REFORM OF THE IMF

THERE ARE AT LEAST FIVE AREAS WHERE THE IMF SHOULD BE REFORMED AND/OR STRENGTHENED:

- GOVERNANCE.
- SURVEILLANCE.
- RESOURCES.
- SDR'S.
- LENDING FACILITIES.

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4. THE ROLE OF CENTRAL BANKS

- CENTRAL BANKS SHOULD PLAY AN ACTIVE ROLE IN THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE.
- THE TRANSFORMATION OF CENTRAL BANKS THEMSELVES IS AN ESSENTIAL PART OF THIS PROCESS.
- IN FACT, SUCH A TRANSFORMATION HAS ALREADY BEGUN.

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4. THE ROLE OF CENTRAL BANKS

- THE MONETARY AUTHORITIES IN MANY COUNTRIES HAVE RESPONDED TO THE GLOBAL FINANCIAL CRISIS WITH EXTRAORDINARY MEASURES.
- AN AGGRESSIVE REDUCTION OF POLICY INTEREST RATES HAS BEEN A FUNDAMENTAL PART OF THESE EFFORTS.
- HOWEVER, MONETARY POLICY IMPLEMENTATION UNDER CURRENT CONDITIONS FACES MAJOR CHALLENGES:
 - INCREASING INTEREST RATE SPREADS.
 - RELUCTANCE BY FINANCIAL INSTITUTIONS TO GRANT CREDIT.
 - EXTREMELY LOW LEVELS OF POLICY INTEREST RATES IN SEVERAL COUNTRIES.

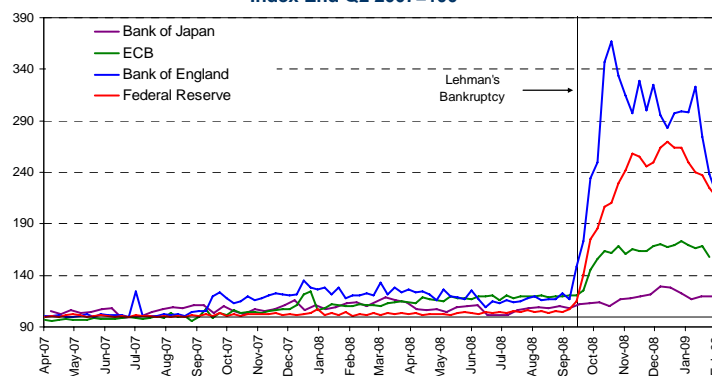
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4. THE ROLE OF CENTRAL BANKS

As traditional tools of monetary policy have reached their limits, a number of central banks have been forced to use unconventional instruments.

Central Banks Total Assets
Index End Q2 2007=100



Source: Central banks.

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4. THE ROLE OF CENTRAL BANKS

- THE USE OF THESE UNCONVENTIONAL INSTRUMENTS HAS BEEN ESSENTIAL.
- BUT WE NEED TO BE AWARE OF A NUMBER OF UNCERTAINTIES RELATED TO THEIR USE.
- FURTHERMORE, IT IS VERY LIKELY THAT THE FINANCIAL CRISIS WILL TRANSFORM OUR UNDERSTANDING OF CENTRAL BANKING IN A NUMBER OF AREAS:
 - LENDER OF LAST RESORT.
 - FINANCIAL STABILITY FUNCTION.
 - PREVENTING ECONOMIC IMBALANCES AND ASSET BUBBLES.
 - INVOLVEMENT OF CENTRAL BANKS IN FINANCIAL REGULATION AND SUPERVISION.
 - CENTRAL BANK CAPITAL.

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4. THE ROLE OF CENTRAL BANKS

- WITH THE CRISIS STILL UNFOLDING, THERE ARE TOO MANY UNKNOWNNS.
- THEREFORE, PROPERLY DISTILLING THE LESSONS FOR CENTRAL BANKING IS GOING TO TAKE TIME.

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5. FINAL REMARKS

- THE CURRENT EPISODE OF TURMOIL HAS SHOWN THAT FINANCIAL CRISES ARE NOT EXCLUSIVE TO EMERGING MARKET ECONOMIES.
- IT IS ALSO EVIDENT THAT PREVIOUS EFFORTS OF REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE ARE INSUFFICIENT.
- FURTHERMORE, THE CRISIS IS GIVING RISE TO AN INCREASE IN PROTECTIONIST SENTIMENT AND A BACKLASH AGAINST GLOBALIZATION.
- WE NEED TO ACT DECISIVELY AND FAST IN MANY AREAS.
- IN PARTICULAR, INCREASED COOPERATION AT BOTH THE NATIONAL AND THE INTERNATIONAL LEVEL IS REQUIRED.

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