RECENT DEVELOPMENTS IN THE INTERNATIONAL FINANCIAL SYSTEM AND IMPLICATIONS FOR CENTRAL BANKING

By

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I. INTRODUCTION

Developments over the past two decades in the international financial system, characterized by financial sector deregulation, globalisation, the integration of financial markets and innovation of financial services products have profound implications for investment and production activities of nation states and policy choices for macroeconomics management. Notably, while the removal on institutional and territorial barriers to competition in the provision of financial services has resulted in efficiency gains in resources allocation, both at the national and global levels, the risks posed by these developments to the promotion of banking and financial soundness as well as the effectiveness of monetary policy by central banks are considerable. Indeed, recent financial market crises in a number of industrial and developing countries and the contagion effect on economies outside the troubled regions have put to question the efficacy of existing strategies and institutional framework for international economic relations to contain and prevent the reoccurrence of these problems.

Although appreciable progress appear to have been made to address some of the problems that caused the financial crises, central banks need to adopt a more comprehensive approach in meeting the challenges posed by the effect of financial liberalisation and product innovation in fighting inflation and ensuring sound financial systems.

The objective of this paper, therefore, is to review recent developments in the international financial scene and assess their impact on the effectiveness of central banks' effort to meet their primary mandate. For ease of exposition, the rest of the paper has been divided into four sections. In section two, we take a cursory view of recent developments in the international financial system, while section three identifies some of the challenges for central banking activities. In section four, we outline policy implications and response to those developments. The paper is concluded in the fifth and final section.

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II. RECENT DEVELOPMENTS

(a) Financial Integration

In recent years, the integration of financial markets at the regional and global levels has advanced significantly, creating a vast pool of financial resources for investment, economic growth and social advancement. Since the beginning of the 1970s throughout the early 1980's many advanced countries had embarked on the process of deregulating their financial systems and liberalising domestic foreign exchange and capital markets. Helped by improvements in communications and information technology, these developments have resulted in a significant fall in transaction costs. The positive effect on international capital flows that followed were initially limited largely to off-shore banking centres but have since the mid-1980's been extended to an increasing number of domestic money and security markets. For example, cross border transactions in bonds and equities in the major industrial countries that were less than 10 per cent of GDP in 1980 increased generally to over 100 percent of GDP in 1995. Moreover, the daily turnover in foreign exchange market increased from about $2,000 million in the mid-1980's to around $1.2 trillion in 1995, equivalent of 85 per cent of all countries' foreign exchange reserves.

A further positive indicator of the integration of financial markets has been the significant narrowing of interest rates differentials between on shore and off-shore lending. For developing countries, capital flows picked up substantially, particularly in many Asian countries that had been more successful in lifting controls in cross border flows. Those countries had removed all foreign exchange restrictions on current account transactions (of goods, services and interest payments), thus accepting the obligations of Article VIII of the IMF Articles of Agreement. Currently, about 100 developing countries have liberalized current account transactions, more than doubled the number in the mid-1980s. Indeed, a number of advanced economies have embarked on the liberalization of capital accounts.

(b) The introduction of European Single Currency (the Euro)

On January 1, 1999, the European single currency, the Euro, was introduced. It marked an arrangement in which eleven of the fifteen member countries of the European Union locked their exchange rates and adopted the EURO as their common currency with monetary and exchange rate policies to be determined by a single central bank. It also involves the unification of the financial markets. The adoption of the EURO represented an important milestone in the process of regional economic integration which has become a global phenomenon in recent times. The introduction of the EURO is expected to have considerable global consequences as its role in international financial transaction could eventually challenge that of the US dollar. The entry of the single currency will no doubt, engender a realignment of currency preferences in the global financial market with ramifications for current account patterns and trade balances.

(c) Financial Crises

A particularly significant development in the international financial system in recent time has been the crises that engulfed many emerging markets starting with the Scandinavian countries and lately a number of Latin American and South East Asian countries as well as Russia. A major factor that precipitated the crises was the deregulation undertaken by those countries before adequate reform of prudential supervision and the regulatory framework was adopted. In addition, financial innovations produced financial derivatives, including futures, swaps and options, that were not amenable to the firm control of regulatory authorities. Indeed, the most commonly cited factor as contributing to the crises was the lax regulatory and supervisory environment that resulted in the financial sector weakness. Moreover, inappropriate monetary policy that resulted in the disorderly behaviour of financial asset prices and culminated in the bursting of asset price baubles was another important contributory factor.

III. PROSPECTS AND CHALLENGES OF RECENT DEVELOPMENTS

(a) Prospects

Reflecting the impact of economic liberalization, relative macroeconomics stability and high growth performance relative of many developing countries, capital inflow have increased rapidly. In the period from 1990 to 1996, for example, net inflows to developing countries more than doubled from \$80 billion in 1990 to more than \$200 billion in 1996, benefiting particularly equity and portfolio investments in emerging market economies. In 1997, the net capital flows further increased to about \$300 billion against a favourable global environment marked by continued growth in demand from industrial countries, low inflation, moderately low interest rates, and continued liquidity in international capital market.

Like free trade, financial integration holds substantial benefits for individual countries and for global economy as a whole. As in the case of trade, the gains of financial integration are large, but the attendant risks and potential costs are equally significant. First, financial integration Could boost growth by raising the level of investment and by improving the returns on investment, through knowledge spillover and market efficiency effect. Financial integration can also boost investment by severing the traditional link between domestic savings and investment. However, the potential gains from higher investment vary from country to country, depending on relative profitability of investment opportunity and on the difference between the domestic and the international cost of capital before integration. Second, financial integration may boost growth by shifting the investment mix towards projects with higher expected returns because of improved ability to diversify the higher risks that are usually implied in higher returns projects. Third, financial integration enhances the depth and efficiency of the domestic financial sector with important feedback to investment and growth. Financial integration has been a source of change in the growth of capital markets in developing countries through its effects on debt and liquidity.

In spite of the substantial potential benefits, the growing financial integration and increased reliance on capital flow could render financial markets more susceptible to volatility, including large reversals in capital flows. This holds true mostly in an environment of weak fiscal policies, badly managed and over protected banking systems and highly distorted domestic financial markets. For instance, international capital flow can act as a magnifying glass on the domestic economy, multiplying the benefits of well-structured reform programmes but, also, increasing the costs of poor economic fundamentals and unsound policies. Moreover, the enormity of capital inflows in relation to the receiving economies raises the spectre of some potential effects that are of concern to policy makers, viz: rising current account deficits as the transfer is effected; excessive money growth and pressures on domestic prices and the real exchange rate; inflows - financed increases in private consumption; and the vulnerability of a sudden reversal of inflows (Susan Schadler - et al, 1993).

Financial integration can give rise to volatility in two ways: first, it can expose economics to new sources of external shocks, and second, it can magnify the effect of domestic shocks. Usually, the main international sources of volatility are changes in asset returns (interest rate and stock market return) and potential investor herding and contagion effects. It is the above scenario that plunged most emerging markets into the turmoil in recent time and generated the tension in the international financial system. The most prominent of the emerging market financial crisis has been the East Asian and Russian financial crisis.

(b) Challenges for Central Banking

The various developments outlined above have altered the financial environment in many countries and made the task of achieving monetary stability and sound financial system more complex. Central banks are thus faced with new challenges that factor in the increasing importance of exogenous factors in their conduct of monetary policy and surveillance activities. The need for dynamism and a more proactive orientation on the part of central banks in order to meet these challenges have become more compelling.

Monetary Policy

The liberalization of domestic financial markets and the concomitant innovation of financial products have altered the channels of monetary policy, affected the relationship between money demand, incomes and interest rates and has thus prompted a reassessment of the appropriate instruments of monetary policy. Indeed, empirical analysis confirms that the relationship between monetary aggregates, income and interest rates exhibited some instability during the 1980s for many Asian countries (Tseng Wanda 1991). This is largely attributable to the effect of financial liberalization and innovation which has resulted to the introduction of financial instruments that are close substitutes for money. Thus, many countries have shifted reliance on targeting specific monetary aggregates and, instead, have monitored a number of financial indicators. This eclectic approach to monetary policy is being replaced by inflation targeting in an increasing number of countries as the objective of low inflation has become central to central banks' primary mandate.

Furthermore, greater emphasis has been placed on indirect market-based instruments most notably open market operations (OMO), for influencing interest rates and monetary conditions, in preference to direct controls on credit and interest rates. This has become necessary because liberalization and new financial products have created opportunities for the circumvention of direct control measures and because of the efficiency of OMO in allocating financial resources. Consistent with these developments the independence of central banks has become central to effective conduct of monetary policy and has assumed a global phenomenon.

Regulatory and Supervisory Activities

The recent financial system crises have brought the issue of banking and financial system soundness to the centre stage. Moreover, there is increasing awareness that the effectiveness of monetary policy requires, as a pre-condition, a sound banking and financial environment, better regulation and supervision which are key to ensuring financial soundness. Regulation includes licensing requirements and the imposition of prudential standards, while supervision involves the monitoring and enforcement of these standards. Given the complexity and pace of innovation in modern financial markets, as well as the scope for, and difficulty of detecting fraud or mismanagement, effective monitoring requires a constant process of probing, analyzing, and questioning banks' activities and data (Stanley Fischer, 1997). And, in view of the growing global integration of financial markets, the importance of co-ordination in central banks' surveillance activities cannot be over-emphasized. Without co-ordination, financial institutions could face different institutional and regulatory environments in the various countries. This would encourage financial institutions to actively search for regulatory loopholes or more benign regulations that could increase risks and reduce credibility of the system. Thus, the need to deepen and, especially, to broaden international supervisory co-ordination is considered as one of the immediate challenges of central banks.

IV. RECENT POLICY INITIATIVES

It is widely acknowledged that vulnerable and unstable banking system can severely disrupt a country's macroeconomic performance. In addition, weaknesses in the banking system of a country can threaten financial stability both within the country and internationally. Hence, the need to improve the strength of financial systems has attracted growing international concern. The reverberations of the recent turmoil in the international financial system, characterized by plunging exchange rates, sharp fall in equity prices and capital flight out of emerging markets, have made it clear that far reaching measures are needed to tackle the weaknesses in the financial system, prevent the emergence of inappropriate external debt profiles and ensure greater transparency in both public and private sector activities. Thus, the international financial community notably, the International Monetary Fund, the World Bank, the Balse Community on Banking Supervision, the Bank for International Settlements and other international pressure groups have articulated measures to strengthen the architecture of the international monetary and financial system in order to guard against systemic risks arising from shifts in market sentiments and the contagion effects of financial crises.

The IMF, in particular, considers that action to help prevent financial crises and resolve them when they occur should focus on sustainable macroeconomics policies based on firm surveillance of policies and practices, sound domestic financial system supported by strong supervisory and regulation framework; transparency in policy making coupled with provision of timely and credible statistical information on performance consistent with internationally accepted framework and standards. In this regard, the IMF adopted the code of Good Practices in Fiscal Transparency to serve as a guide for member countries to increase fiscal transparency and thereby enhance accountability as a key feature of good governance.

In an effort to further strengthen the architecture of the international monetary and financial system, the IMF, working in collaboration with the Bank for International Settlement and in consultation with a representative group of central banks, financial agencies and other relevant international and regional institutions, has developed a Code of Good Practices on Transparency in monetary and financial policies. The Code identifies desirable transparency practices for central banks in their conduct of monetary policies and for other financial agencies in their conduct of financial policies.

The case of transparency of monetary and financial policies is based on two main premises. First, the effectiveness of monetary and financial policies can be strengthened if the goals and instruments of policy are known to the public and if the authorities can make credible commitment to meeting them. In making available more information about monetary and financial policies, good transparency practices promote the potential efficiency of markets. Second, good governance calls for central banks and financial agencies to be accountable, particularly where the monetary and financial authorities are granted high degree of autonomy. In making the objectives of monetary policy public, the central bank enhances the public understanding of what it is seeking to achieve and provides a context for articulating its own policy choices thereby contributing to effectiveness of monetary policy.

The need to strengthen the international financial system has also engaged the attention of some international bodies and organization other than the IMF. These include the Balse Committee on Banking Supervision[1] and the Bank for International Settlement (BIS) which had been in the forefront of compelling best practices and guidelines covering relevant financial activities and arrangement. In particular, in 1997, the committee prepared a comprehensive set of Core Principles for effective banking supervision. The Balse Core Principles comprises twenty-five basic principles that need to be put in place for supervisory system to be effective. These include preconditions for effective banking supervision, licensing and structure prudential regulations and requirements for formal powers of supervision and cross border banking. Being institution charged with the mandate of promoting sound banking and efficient financial system, central banks have a major responsibility in ensuring the effective operationalism of good practices specified in these codes.

Policy Response to Recent Developments in Nigeria

The overall objective of monetary policy in a country is not static, it changes to meet changing economic conditions. However domestic price stability, full employment, economic growth and maintenance of a healthy balance-of-payments position are regarded as the basic objectives of monetary policy in Nigeria as elsewhere. The 1962 Amendment to the Banking Act of 1958 Act gives the Central Bank of Nigeria wider powers to control the financial system by introducing more monetary policy instruments and encouraging the developments of money and capital markets in the country. In 1991, two new decrees were enacted. These were the Central Bank Decree No. 24 of 1991 which repealed the Central Bank of Nigeria Act of 1958 (as amended) and the Banks and other Financial Institutions Decree No. 25 of 1991 which replaced the Banking Decree of 1969 (as amended).

The Central Bank Decree No. 24 of 1991 considerably strengthened the powers of the Central Bank as an agency of Government with responsibility for maintaining monetary stability and a sound financial system in the country. The Banks and other Financial Institutions Decree No. 25 of 1991 which governs the operations of banks and other financial institutions embodies several changes. The decrees placed emphasis on creating an environment of competitive efficiency, financial soundness and sustainable economic growth.

Within the context of financial sector reform, the Central Bank of Nigeria has moved from an era of strict control and regulations underprinted by direct instruments of monetary policy to that of deregulation and liberalisation which emphasises indirect tools of monetary policy. During the period 1980 – 1985, the monetary control framework, the interest rate regime and lack of co-ordination increasingly frustrated the achievement of monetary policy objective. The continued reliance on direct instruments such as credit ceiling and selective credit control increasingly failed to achieve set monetary policy

1. The Balse Committee on Banking Supervision is a Committee of Banking Supervisory Authorities of which was established by the Central Bank Governors, the Group of ten industrialized countries in 1973.

objectives as they became less effective with time. Rigidly controlled interest rate at low levels helped to encourage inflationary monetary expansion without promoting the growth of money and capital markets (Oke 1995). Hence, financial sector reforms constituted integral parts of the structural adjustment programme which was adopted in 1986. Among other objectives, the financial sector reforms aimed at correcting the pervasive distortions introduced into the system through prolonged use of direct controls and improving the efficiency of the financial system in the mobilisation and distribution of financial resources for economic development. The driving force for the shift in approach to economic management from direct control to market based instruments has been the desire to achieve enhanced efficiency in the mobilisation and utilisation of resources. Thus, a major objective of financial sector reform had been to develop an efficient framework for monetary management. This encompasses effort to strengthen operational capacities of the banking system, foster efficiency in money and security market, overhaul the payments system and ensure greater autonomy of the central bank in conducting macroeconomics stabilisation policy (Aderibigbe 1997).

In the face of the continous move towards greater integration of financial markets and the need to avoid the type of crisis that ravaged the same emerging market financial system with contagion effects on other countries, the CBN has placed great emphasis on the promotion of a sound and competitive banking system. Hence, the Bank has since 1990 introduced a number of regulatory measures designed to enhance the capital base of banks and promote a more professional approach to bank lending and provisioning for non-performing bank. Specifically, the risk weighted measure of capital adequacy ratio recommended by the Basle Committee of the Bank for International Settlement was adopted and enforced. Moreover, the Bank introduced a set of prudential guidelines and mandatory uniform accounting standard for all licensed banks.

Although deregulation has improved the financial sector significantly, since 1996, the sector continues to be adversely affected by some outstanding problems such as financial sector distress which has been boldly addressed by the authorities especially with the liquidation of 26 terminally distress banks in early 1998. The need to address the distress in the system especially, as it relates to community banks and development finance institutions has been recognized. An effective mechanism for addressing the problem is being put in place.

V. CONCLUSION

The increasing globalisation of financial markets has created a vast pool of resources for investment, economic growth and social advancement. The financial turmoil that erupted in South East Asia in 1997 and the Russian financial crisis in 1998 had profound impact on the world economy and international financial system. The reverberation of these crises has produced serious systemic effects on many economies of the world, including those in Africa. These crises have demonstrated that countries need a strong and stable financial system in order to successfully withstand speculative attacks and sudden reversal of capital flows. They also have underscored the relevance of having a sound financial system to fully benefit from liberalised capital movements. The international financial institutions have undertaken enormous ground work in providing the elements of a sound financial system and other standards by establishing codes of good practices in monetary and financial policies. A strengthened domestic financial system and stricter prudential regulations and financial sector supervision clearly constitute an indispensable element in improving the architecture of the global monetary system. The recent development in the international financial system and the emerging market crises pose tremendous challenges to central banks in the discharge of their functions of maintaining a sound and efficient financial system.

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