REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

Chapter III

TOWARDS REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE: WHICH WAY FORWARD?

A. Introduction

The increased frequency and virulence of international currency and financial crises, involving even countries with a record of good governance and macroeconomic discipline, suggests that instability is global and systemic. Although there is room to improve national policies and institutions, that alone would not be sufficient to deal with the problem, particularly in developing countries, where the potential threat posed by inherently unstable capital flows is much greater. A strengthening of institutions and arrangements at the international level is essential if the threat of such crises is to be reduced and if they are to be better managed whenever they do occur. Yet, despite growing agreement on the global and systemic nature of financial instability, the international community has so far been unable to achieve significant progress in establishing effective global arrangements that address the main concerns of developing countries.

In the aftermath of the Asian crisis a number of proposals have been made by governments, international organizations, academia and market participants for the reform of the international financial architecture.[1] They cover broadly four areas: global rules and institutions governing international capital flows; the exchange rate system; orderly workouts for international debt; and the reform of the IMF, with special reference to surveillance, conditionality, the provision of international liquidity, and its potential function as lender of last resort. Implementation of any of these proposals would entail the creation of new international institutions and mechanisms as well as reform of the existing ones.

Some of these proposals have been discussed in the IMF itself, as well as in other international financial institutions, such as BIS and the newly established Financial Stability Forum (FSF), and also among the Governments of G-7 countries. While certain initiatives have been taken as a result, the reform process, rather than focusing on international action to address systemic instability and risks, has placed emphasis on what should be done by national institutions and mechanisms. Even in this regard it has failed to adopt an even-handed approach between debtors and creditors. Efforts have concentrated on disciplining debtors, setting guidelines and standards for major areas of national policy, principally in debtor countries,

and providing incentives and sanctions for their implementation. Debtor countries have been urged to better manage risk by adopting strict financial standards and regulations, carrying adequate amounts of international reserves, establishing contingent credit lines and making contractual arrangements with private creditors so as to involve them in crisis resolution. The international financial system has continued to be organized around the principle of *laissez-faire,* and developing countries are advised to adhere to the objective of an open capital account and convertibility, and to resort to controls over capital flows only as an exceptional and temporary measure. All this has extended the global reach of financial markets without a corresponding strengthening of global institutions.

The failure to achieve greater progress is, to a considerable extent, political in nature. The proposals referred to above have often run into conflict with the interests of creditors. But governments in some debtor countries also oppose reform measures that would have the effect of lowering the volume of capital inflows and/or raising their cost, even when such measures could be expected to reduce instability and the frequency of emerging-market crises. Many observers have been quick to dismiss such proposals as not only politically unrealistic but also technically impossible. However, as long as systemic failure continues to threaten global welfare, resistance to more fundamental reform of the international financial architecture must be overcome:

> It is easy to fall into the trap of thinking that big institutional changes are unrealistic or infeasible, especially in the United States where macroeconomic policy institutions have generally evolved only slowly for the past few decades. Not so long ago, the prospects for a single European currency seemed no more likely than those for the breakup of the Soviet empire or the reunification of Germany. Perhaps large institutional changes only seem impossible until they happen – at which point they seem foreordained. Even if none of the large-scale plans is feasible in the present world political environment, after another crisis or two, the impossible may start seeming realistic. (Rogoff, 1999: 28)

Rather than focusing on international action to address systemic instability and risks, the reform process has placed emphasis on what should be done by national institutions and mechanisms. Even in this regard it has failed to adopt an even-handed approach between debtors and creditors.

Part Two of this Report reviews the main initiatives undertaken so far in the reform of the international financial architecture, and the advice given to developing countries in some key policy areas, such as structural reforms and exchange rate policy, for the prevention and management of instability and crises. The discussion follows from an earlier analysis, made in *TDR 1998*, and concentrates on more recent developments. This chapter provides an overview of the issues, comparing briefly what has so far been achieved with the kind of measures proposed in order to address systemic failures and global instability. The next chapter reviews recent initiatives regarding global standards and regulation, while chapter V discusses whether developing countries can both keep an open capital account and avoid currency instability and misalignments by choosing appropriate exchange rate regimes, despite persistent misalignments and gyrations of the three major reserve currencies and large swings in international capital flows. It also assesses the scope for regional cooperation for establishing collective defence mechanisms against financial instability, drawing on the EU experience. The final chapter takes up the question of the management of financial crises and burden-sharing, and discusses the current state of play in two crucial areas, namely the provision of international liquidity and the involvement of the private sector in crisis management and resolution.

B. The governance of international capital flows

As the Second World War drew to an end, a set of organizations was envisaged which would deal with exchange rates and international payments, the reconstruction and rehabilitation of war damaged economies, and international trade and investment. The institutions established to handle these issues were the IMF, the World Bank, and the GATT. However, international capital movements did not fall within their purview. The original structure did not include a global regime for capital movements in large part because it was considered that capital mobility was not compatible with currency stability and expansion of trade and employment. However, no such regime was established even after the breakdown of the Bretton Woods arrangements, despite the growing importance of private capital flows (Akyüz and Cornford, 1999: 1–7).

The only global regime applying to cross-border monetary transactions was that of the IMF, but the most important obligations in its Articles of Agreement relate to current and not capital transactions. Concerning the latter, Article IV states that one of the essential purposes of the international monetary system is to provide a framework facilitating the exchange of capital among countries, a statement which is included among general obligations regarding exchange arrangements. The more specific references to capital transfers, in Article VI, permit recourse to capital controls so long as they do not restrict payments for current transactions, and actually give the Fund the authority to request a member country to impose controls to prevent the use of funds from its General Resources Account to finance a large or sustained capital outflow. The only recent initiative regarding the global regime is the attempt to include capital convertibility among the objectives of the IMF.

The BIS was originally set up as a forum for a small number of countries to deal with only certain aspects of international capital flows.[2] Since the 1970s it has provided secretariat support for a number of bodies established to reduce or manage the risks in cross-border banking transactions. These bodies are not responsible for setting rules for international capital movements as such. Their work is aimed at reaching agreements on standards to be applied by national authorities for strengthening the defences of financial firms, both individually and in the aggregate against destabilization due to cross-border transactions and risk exposures.

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The increased frequency of financial crises, together with the increasingly global character of financial markets, has prompted both analysts and practioners to formulate proposals for the creation of a number of international institutions explicitly designed to regulate and stabilize international capital flows. One such proposal is for the creation of a global mega-agency for financial regulation and supervision, or World Financial Authority, with responsibility for setting regulatory standards for all financial enterprises, offshore as well as onshore (Eatwell and Taylor, 1998; 2000).

Another proposal is to establish a Board of Overseers of Major International Institutions and Markets, with wide-ranging powers for setting standards and for the oversight and regulation of commercial banking, securities business and insurance.[3] Yet another proposal, which focuses on stabilizing international bank lending, is for the establishment of an International Credit Insurance Corporation designed to reduce the likelihood of excessive credit expansion (Soros, 1998).

These proposals are based on two arguments. The first is that, since financial businesses are becoming increasingly interrelated and operate across borders, their regulation and supervision should also be carried out on a unified and global basis. The second argument focuses on the instability of capital movements under the present patchwork of regimes, which only more globally uniform regulation could be expected to address. Whatever their specific strengths and weaknesses, these proposals emphasize the need for international institutions and mechanisms that can prevent excessive risk-taking in cross-border lending and investment, reduce systemic failures, and eliminate several, often glaring, lacunae in the national regulatory regimes of creditor and debtor countries. The official approach to these problems has been quite different, focusing on lowering the risk of financial distress and contagion by strengthening the domestic financial systems in debtor countries. It has also emphasized the provision of timely and adequate information regarding the activities of the public sector and financial markets in debtor countries in order to allow international lenders and creditors to make better decisions, thereby reducing market failure, as well as to improve bilateral surveillance.

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As examined in some detail in chapter IV, various codes and standards have been established through institutions such as the IMF, BIS and the FSF not only for the financial sector itself, but also in respect of macroeconomic policy and policy regarding disclosure. While their application should be generally beneficial, particularly over the long term, they will not necessarily contribute to financial stability, and in many cases they will involve substantial initial costs. Moreover, the programmes of reform required of recipient countries are wide-ranging and do not always accommodate differences in levels of development and the availability of human resources.

Considered from the standpoint of systemic reform, the reform package contains many omissions and reflects an asymmetric view of different parties' responsibilities for the changes required. In particular, it does not adequately address the concerns of developing countries over the frequently supply-driven character of fluctuations in international capital flows, which are strongly influenced by monetary conditions in major industrial countries, especially the United States, and over the liquidity positions and herd behaviour of lenders and investors in those countries. The obligations contained in the new codes and standards initiatives seem to reflect the view that the main flaws in the system for international capital movements are to be found in recipient countries, which should thus bear the main burden of the adjustments needed to prevent or contain financial crises. By contrast, new measures to reduce volatile capital flows at source or to increase the transparency of currently largely unregulated cross-border financial operations are notable mostly for their inadequacy or their complete absence. The recommendations directed at source countries call for only limited actions that are beyond the bounds of existing policies or initiatives or involve changes in market practices beyond those already being undertaken.

Despite the emphasis on ownership and voluntary participation, implementation of the codes and standards is to be backed by an extensive system of externally applied incentives and sanctions, some of which risk becoming features of IMF

conditionality. Although the rules and guidelines are mostly of a fairly general nature, there remains a danger that their actual implementation will incorporate elements from particular developed-country models, owing to the role in assessment exercises of multilateral financial institutions and supervisors from G-7 countries. As one writer has put it:

> … there are dangers in throwing at developing countries a Washington-consensus view of economic policy, even if this consensus is now refurbished with new international codes and standards and with "second-generation reforms". The dangers arise from several sources. First, the new set of external disciplines come hand-in-hand with a particular model of economic development of doubtful worth … Second, it is doubtful that the new policy agenda will make the international system itself much safer. … Indeed, by focusing attention on internal structural reforms in the developing world, the current approach leads to complacency on short-term capital flows, and could increase rather than reduce systemic risks. Finally, the practical difficulties of implementing many of the institutional reforms under discussion are severely underestimated. (Rodrik, 1999: 3)

What has been proposed so far under the heading of codes and standards falls well short of amounting to an integral component of a new global policy framework for reducing financial instability. It should be recalled that an essential element of the rationale of the codes and standards initiatives consisted of their role as the necessary counterpart of further financial liberalization, particularly in developing economies. But the initiatives currently under consideration hardly justify imposing further obligations on countries as to capital-account convertibility, cross-border investment, or the liberalization of financial services more generally. In the absence of effective global action, much of the burden of coping with international financial instability still falls on national governments. It is thus vital that they remain free in their choice of policy.

C. The exchange rate system

The second key area in the reform of the international financial architecture is the exchange rate system, notably the arrangements regarding the three major reserve currencies (the dollar, the euro and the yen). Indeed, it would be more appropriate to speak of the need to establish a global system of exchange rates rather than reform the existing system; ever since the breakdown of the Bretton Woods system of fixed, but adjustable, exchange rates there have in effect been no global arrangements. While floating was adopted on the understanding that success depended upon the prevalence of orderly underlying conditions, the international arrangements to that end as specified in the Articles of Agreement of the IMF, and in the April 1977 decision on exchange rate arrangements, failed to define the obligations and commitments that such arrangements involved. As pointed out by Robert Triffin, the obligations were "so general and obvious as to appear rather superfluous", and the system "essentially proposed to legalize … the widespread and illegal repudiation of Bretton Woods commitments, without putting any other binding commitments in their

place" (Triffin, 1976: 47–48). While the April 1977 decision required members to "intervene in the exchange market if necessary to counter disorderly conditions", it failed to define these conditions and to provide explicit guidelines for intervention. Similarly, the principles of surveillance over exchange rate policies "were sufficiently general for constraint on behaviour to depend almost entirely on the surveillance procedures" (Dam, 1982: 259), and the consultation procedures have so far failed to generate specific rules of conduct that could lend support to any contention that the present arrangements constitute a "system".[4]

Given this institutional hiatus and lack of policy coordination among the major industrial countries, it should come as no surprise that floating has failed to deliver what was originally expected: reasonably stable exchange rates; orderly balance-of-payments adjustment; greater macroeconomic policy autonomy; and removal of asymmetries between deficit and surplus countries. Rather, the system is characterized not only by short-term volatility, but also by persistent currency misalignments and gyrations. The major industrial countries have continued to favour floating and have refrained from intervening in currency markets except at times of acute stress and imbalances, such as the events leading to agreements on coordinated monetary policy actions and exchange market interventions in the Plaza and Louvre Accords of 1985 and 1987, respectively.

The damage inflicted by disorderly exchange rate behaviour tends to be limited for the reserve currency (G-3) countries themselves, compared to developing countries, because they have large economies that are much less dependent on international trade. Moreover, the exposure of their economic agents to exchange rate risks is limited because they can both lend and borrow in their national currencies. By contrast, exchange rate misalignments and gyrations among the G-3 currencies are a major source of disturbance for developing countries that has played an important role in almost all major emerging-market crises (Akyüz and Cornford, 1999: 31). Thus, the question arises whether it is meaningful to predicate attainment of exchange rate stability by emerging-market countries purely on their adoption of appropriate macroeconomic policies and exchange rate regimes when the currencies of the major industrial countries are still so unstable. Indeed, many observers have suggested that the global economy will not achieve greater systemic stability without some reform of the G-3 exchange rate regime, and that emerging markets will continue to be vulnerable to currency crises as long as the major reserve currencies remain highly unstable.

Can emerging-market countries attain exchange rate stability purely by adopting appropriate macroeconomic policies and exchange rate regimes when the currencies of the major industrial countries are still so unstable? The exchange rate system as such has hardly figured on the agenda for the reform of the international financial architecture.

Certainly, given the degree of global interdependence, a stable system of exchange rates and payments positions calls for a minimum degree of coherence among the macroeconomic policies of major industrial countries. But the existing modalities of multilateral surveillance do not include ways of attaining such coherence or dealing with unidirectional impulses resulting from changes in the monetary and exchange rate policies of the United States and other major industrial countries. In this respect governance in macroeconomic and financial policies lacks the kind of multilateral disciplines that exist for international trade.

One proposal to attain stable and properly aligned exchange rates is through the introduction of target zones among the three major currencies together with a commitment by the countries to defend such zones through coordinated intervention and macroeconomic policy action.[5] It is felt that such a commitment would secure the policy coherence needed for exchange rate stability without undermining growth and could alter the behaviour of currency markets, which, in turn, would reduce the need for intervention. Such an arrangement could be institutionalized and placed under IMF surveillance.

A more radical proposal is to do away with exchange rates and adopt a single world currency, to be issued by a World Monetary Authority which could also act as a lender of last resort. There has been growing interest in such an arrangement since the introduction of the euro and the recurrent currency crises in emerging markets. However, it is generally felt that the present extent of economic convergence and depth of global integration fall far short of what would be required for such an arrangement to operate effectively (Rogoff, 1999: 33–34).

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In any event, it is interesting to note that the exchange rate system has hardly figured on the agenda for the reform of the international financial architecture. The report by the then Acting Managing Director of IMF to the International Monetary and Financial Committee (IMF, 2000b) recognized the difficult choice faced by most countries between maintaining, on the one hand, truly flexible rates and, on the other, hard pegs. Referring to the three major currencies, the report pointed to "large misalignments and volatility" in their exchange rates as a cause for concern, particularly for small, open commodity-exporting countries. However, it did not discuss any initiatives that might be taken by the international community in this respect, implying that the matter could only be sorted out between the United States, Japan and the EU (see also Culpeper,

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raised as to whether the existence of so many independent currencies makes sense in a closely integrated global financial system.

However, much of this is a false debate. Whichever option is chosen, it will not be able to ensure appropriate alignment and stability of exchange rates in developing countries as long as major reserve currencies themselves are so unstable and misaligned, and international capital flows are volatile and beyond the control of recipient countries. Moreover, such conditions create inconsistencies within the developing world in attaining orderly exchange rates. Briefly put, there is no satisfactory unilateral solution to exchange rate instability and misalignments in emerging markets, particularly under free capital movements.

Since global arrangements for a stable system are not on the immediate agenda, the question arises as to whether regional mechanisms could provide a way out. Indeed, there is now a growing interest in East Asia and some countries of South America in regionalization (as opposed to dollarization) as a means of providing a collective defence mechanism against systemic failures and instability. The EU experience holds useful lessons in this respect, including the institutional arrangements for the maintenance and adjustment of intraregional currency bands, intervention mecha-

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