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THE DEBATE ON THE INTERNATIONAL FINANCIAL ARCHITECTURE: REFORMING THE REFORMERS

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Yilmaz Akyüz *

This paper briefly surveys the progress made in various areas of reform of the international financial architecture since the outbreak of the East Asian crisis, and explains the principal technical and political obstacles encountered in carrying out fundamental changes capable of dealing with global and systemic instability. It ends with a brief discussion of what developing countries could do at the global, national or regional level to establish defence mechanisms against financial instability and contagion.

Introduction

After the recent bouts of turbulence and instability in international currency and financial markets – including the 1992/93 EMU crisis – large gyrations in the exchange rate of the dollar,[1] and the emerging market crises in Mexico, East Asia, Russia and Brazil, a consensus seemed to emerge that instability was global and systemic, national efforts would not be sufficient to deal with the problem, and there was a need to overhaul and indeed reconstruct the global financial architecture. The ensuing debate has concentrated mainly on the following areas:

(i) standards and transparency;
(ii) financial regulation and supervision;
(iii) management of the capital account;
(iv) exchange rate regimes;

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* UNCTAD, Geneva. An earlier version of this paper was presented at a meeting of the Global Development Network (GDN.99), "Bridging Knowledge and Policy", Bonn, Germany, 5B8 December 1999. For a more detailed discussion of many of the issues taken up here, see Akyüz and Cornford (1999).

[1] The dollar swung from 79 yen in the spring of 1995 to about 150 yen in 1997, coming back to some 100 yen at the end of the decade. During the past year it showed substantial gyrations against the yen, sometimes changing by 15B20 per cent within weeks.

(v) surveillance of national policies;

(vi) provision of international liquidity; and

(vii) orderly debt workouts.

Measures under these headings can help to prevent or manage financial crises, and sometimes serve both objectives simultaneously. Clearly, reforms in these areas generally imply significant changes in the operating procedures and governance of the Bretton Woods institutions (BWIs), notably the IMF. Indeed, these issues are often addressed in the context of the reform of these institutions, as in the case of the recent Meltzer Commission Report presented to the United States Congress.

A number of proposals have been made since the Asian crisis in these areas by governments, international organizations, private researchers and market participants. Some of these proposals have been discussed in international institutions such as the IMF, BIS and the newly-established Financial Stability Forum. A close look at a recent IMF report reviewing the progress so far made shows that many of the proposals and actions considered in these fora have concentrated on marginal reform and incremental change rather than on the big ideas that emerged in the wake of the East Asian financial crisis.[2] More specifically, attention has focused on standards and transparency, and, to a lesser extent, financial regulation and supervision while efforts have been piecemeal or absent in the more important areas addressing systemic instability and its consequences. With stronger-than-expected recovery in East Asia, the containment of the damage in Russia and Brazil, and rebound of Western stock markets, emphasis has increasingly shifted towards costly self-defence mechanisms and greater financial discipline in debtor countries. Developing countries are urged to adopt measures such as tight national prudential regulations to manage debt, higher stocks of international reserves and contingent credit lines as a safeguard against speculative attacks, and tight monetary and fiscal policies to secure market confidence, while maintaining open capital account and convertibility. Big ideas for appropriate institutional arrangements at the international level for global regulation of capital flows, timely provision of adequate international liquidity with appropriate conditions, and internationally sanctioned arrangements for orderly debt workouts have not found favour among the powerful. Some "very big ideas" did not even make to the agenda of the international community as they were presumably found to be too radical to deserve official attention. These include:

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[2] For a summary of the proposals discussed and actions so far taken in the IMF, see IMF (1999a).

(i) A proposal by George Soros to establish an International Credit Insurance Corporation, designed to reduce the likelihood of excessive credit expansion;

(ii) A proposal by Henry Kaufman 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;

(iii) A similar proposal 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, off-shore as well as on-shore entities;

(iv) The proposal to establish a genuine international lender-of-last-resort with discretion to create its own liquidity;

(v) The proposal to create an international bankruptcy court in order to apply an international version of chapter 11 of the United States Bankruptcy Code for orderly debt workouts;

(vi) The proposal to manage the exchange rates of the G3 currencies through arrangements such as target zones, supported by George Soros and Paul Volcker;

(vii) The Tobin tax to curb short-term volatility of capital movements and exchange rates.

There are certainly conceptual and technical difficulties in designing reasonably effective global mechanisms for the prevention and management of financial instability and crises. Such difficulties are also encountered in designing national financial safety nets, and explain why it is impossible to establish fail-safe systems. At the international level there is the additional problem that any system of control and intervention would need to be reconciled with national sovereignty, diversity and conflicting interests. For all these reasons it is not realistic to expect replication of national financial safety systems at the international level involving global regulation, supervision and insurance mechanisms, an international lender-of-last resort and international bankruptcy procedures.

However, political constraints and conflict of interest, rather than conceptual and technical problems, appear to be the main reason why the international community have not been able to achieve even a modest real progress in setting up effective global arrangements for the prevention and management of financial crises. However, political disagreements are not only between industrial and developing countries. There have also been considerable differences among the G7 members regarding the nature and direction of reforms. A number of proposals made by some G7 countries for regulation, control and intervention in the financial and currency markets have not enjoyed consensus, in large part because of the opposition of the United States.

By contrast agreement among G7 has been much easier to attain in areas aiming at disciplining the debtor developing countries.

It seems that a rules-based global financial system with explicit responsibilities of creditors and debtors, and well-defined roles for public and private sectors is opposed by major industrial powers which continue to favour a case-by-case approach because, *inter alia*, such an approach gives them considerable discretionary power due to their leverage in international financial institutions. However, it is not clear if such a system would be desirable from the point of view of smaller countries, particularly developing countries. For, it is not realistic to envisage that a rules-based global financial system could be established on the basis of a distribution of power markedly different from that of existing multilateral financial institutions. It would likely reflect the interest of larger and richer countries, rather than redressing the imbalance between international debtors and creditors. Such biases against developing countries exist even in the so-called rules-based trading system[3] where the North-South relation is a great deal more symmetrical than in the sphere of finance where developing countries are almost invariably debtors and industrial countries creditors.

Indeed, developing country governments have not always been supportive of proposed measures for reform. In a sense they have been ambivalent about the reform of the system, even though, because of their greater vulnerability, this is an issue deserving top priority for them. In many cases, this is motivated by their desire to retain policy autonomy. But they have also opposed measures, at national or global level, 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 be effective in reducing instability and the frequency of crises in emerging markets:

(i) A large majority of developing countries have been unwilling to impose control on capital inflows during the boom phase of the financial cycle with the objective of moderating them and