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Strengthening the International Financial Architecture

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STRENGTHENING THE INTERNATIONAL FINANCIAL ARCHITECTURE*

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Foreword

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The severity of Asia's financial crisis, the speed with which it spread, and the shortcomings of the international response have all contributed to a wide-ranging debate on the basic rules and institutions that govern global finance. How can this global financial architecture be improved so that crises can be avoided and can be better managed when they do occur?

BACKGROUND

Recent efforts to improve the global financial architecture began at the Halifax Summit of the G7 leaders in 1995. In the wake of Mexico's financial crisis, policymakers already felt that global institutions and rules needed to be updated to cope with a modern world of integrated capital markets. The existing Bretton Woods architecture had originally been designed for a world where capital mobility was limited (Box 1). Even though it had evolved over the years, financial markets had changed far more profoundly.

As official discussions on an international financial architecture have proliferated since 1995, so an increasing number of organizations have become involved (Box 2). In addition, a number of individual academics and other commentators have put forward their own reform proposals. The result is a plethora of ideas. However, few concrete changes have occurred. This is partly because international institutions and policymakers have been preoccupied with the immediate task of crisis management, but mainly because the issue of international financial reform is extraordinarily complex.

US Secretary Designate of the Treasury Lawrence Summers recently referred to the "integration trilemma" (Summers 1999). He noted that in the years ahead the central task of international political economy will be to reconcile as well as possible the three goals of greater integration, proper public management, and national sovereignty. In effect, policymakers would like the international financial system to fulfill a number of goals. They would like to foster capital market integration, they would like international financial markets to be regulated and supervised just as national

Box 1: The Existing Bretton Woods Financial Architecture

The IMF and the World Bank were set up at the Bretton Woods Conference in 1944 to prevent a repeat of the international financial problems that had occurred during the Great Depression. The IMF was to oversee the Bretton Woods system of fixed exchange rates and the World Bank was to provide capital for postwar reconstruction, and later for projects in developing countries. Plans for a third institution, the International Trade Organization, foundered in 1947 when the US Congress refused to accept it. In its place, the "provisional" General Agreement on Tariffs and Trade took on the role of reducing international trade barriers through a series of eight multilateral negotiating rounds. Eventually, on 1 January 1995, the World Trade Organization came into existence.

The World Bank's goal was to provide foreign exchange and technical assistance for development projects, particularly physical infrastructure such as bridges and dams. During the past 50 years its role has broadened to include virtually all aspects of the development process. Later a number of regional banks were founded, including the ADB. Their regional proximity and smaller size led them to be more innovative in some respects.

The IMF oversaw the Bretton Woods exchange rate regime. The aim of the Bretton Woods system was to enable countries to achieve full employment and balance-of-payments equilibrium simultaneously. Temporary deficits were to be covered from a country's own reserves and, if necessary, by loans from the IMF. Only fundamental balance-of-payment problems, that is, ones that could not be corrected without excessive unemployment or inflation, were to be corrected by exchange rate changes. The IMF's Articles of Agreement called for convertibility of current account transactions only. Article VI, section 3, gives members the right to apply controls on capital flows. In 1997 the Interim Committee—the advisory body that oversees the IMF—recommended that the Articles of Agreement be amended to extend jurisdiction to issues relating to orderly liberalization of capital markets.

The Bretton Woods system depended on countries' willingness to hold their reserves in US dollars. This, in turn, was conditional on their expectation that they could convert dollars into gold at a fixed price. In the mid-1960s, as US inflation rates rose, partly because of the cost of the Viet Nam War, confidence in the dollar's convertibility began to erode. The system collapsed after President Nixon abandoned the US dollar's convertibility in 1971 and the fixed exchange rate regime broke down.

After the breakdown of the Bretton Woods regime, the IMF formally began to oversee the new "system" of floating exchange rates. In practice, its focus moved to the developing world. It played a central role during the debt crisis of the 1980s, coordinating lender banks and providing adjustment finance. In the 1990s it has assisted formerly communist economies in their transition to market economies and has played a central role in combating financial crises.

Box 2: Too Many Architects Spoil the Blueprint?

At the last major restructuring of the international financial system in 1944—the Bretton Woods Conference—all the major participants were comfortably housed in a single rural hotel in New Hampshire. The views of just two people, John Maynard Keynes representing the United Kingdom and Harry Dexter White for the United States, dominated the conference. A comparable conference today would probably need every hotel room in a medium sized American city. With so many different agendas and vested interests, discussion on any proposals (if, indeed, any agreement could be reached) would take far longer than the deliberations at Bretton Woods.

Today a number of official groups are involved, all of which have their own ideas on how to proceed. The best known of these is the G7, which consists of the seven most influential industrial countries, and whose current membership was determined at a summit meeting in 1976. This group has become the focal point for international cooperative efforts. Indeed, it was the G7 that coined the term financial architecture in 1995, and the G7 finance ministers have worked regularly on this issue. The most recent initiative of the G7 in this regard is the creation of a financial stability forum.

The G10 is an older group, set up in 1962, and includes 11 industrial countries (Switzerland joined later, but the name was not changed). It consists of central bank governors and finance ministers, and consequently focuses on international financial matters. The group is closely related to the Basle Committee on Banking Supervision, and both groups are based in the offices of the Bank for International Settlements. Europe tends to dominate the group, with 8 of the 11 members being European countries.

The G22 is an ad hoc group of countries set up by the United States in April 1998 and includes a number of emerging market countries. At its first meeting three working groups were set up to examine issues of enhancing transparency and accountability, strengthening financial systems, and managing international financial crises. These working groups delivered their reports in October 1998. At the request of several small European countries, the G22 was expanded to become the G26; however, it has not met formally again.

Despite their overlapping memberships, the various groups bring a wide range of different views and perspectives to the discussions of the international financial architecture. While these different viewpoints no doubt enrich the discussions, whether this plethora of architects will eventually contribute to a more solid architecture or merely generate too much dissension and divergence about the blueprint remains to be seen.

Note: The G7 consists of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The G10 includes the G7 plus Belgium, the Netherlands, Sweden, and Switzerland. The G22 comprises the G7 and 15 emerging market economies (Argentina; Australia; Brazil; PRC; Hong Kong, China; India; Indonesia; Korea; Malaysia; Mexico; Poland; Russia; Singapore; South Africa; and Thailand). The G26 consists of the G22 plus Belgium, Netherlands, Sweden, and Switzerland, that is, the four countries included in the G10 but not in the G7.

markets are regulated and supervised, and they would like to maintain national sovereignty. Unfortunately, these three goals are incompatible: maintaining national sovereignty in a world of free capital means forfeiting market regulation and support. Conversely, to create regulations and a lender of last resort at the international level implies overriding national sovereignty. The only way that a country can regulate and support its financial markets while maintaining national sovereignty is by controlling capital flows.

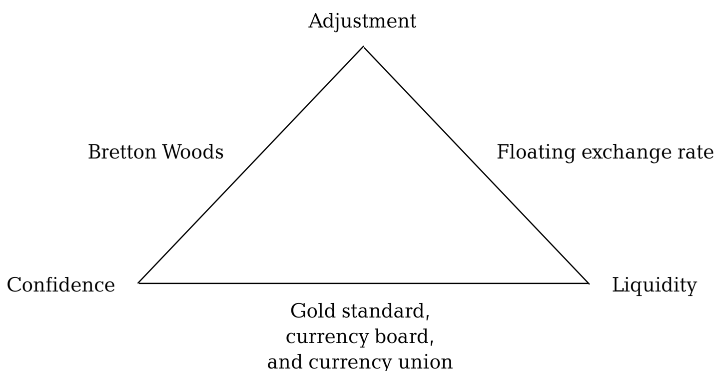
This incompatibility of goals is particularly striking in the area of exchange rate management. Policymakers want the benefits of capital market integration, they want exchange rate stability, and they want each country to be able to pursue its own macroeconomic policy. Unfortunately, these three goals are at odds. They form what economists Obstfeld and Taylor (1998) have called the "open economy trilemma."

To understand why, consider Figure 1. Each corner of the triangle represents one of the policymakers' three goals, and each side of the triangle indicates a possible regime. "Adjustment" means that a country can pursue independent macroeconomic policies. If the economy is slowing down, for instance, the country can adjust by reducing interest rates. "Confidence" denotes the ability to protect exchange rates from destabilizing speculation. With confidence, trade and investment flows are encouraged. "Liquidity" refers to the ability to borrow money from abroad through the free flow of capital. For countries to have this liquidity, international capital flows must be free. Unfortunately, it is only possible to achieve two of these goals at once.

Suppose a country wants a stable exchange rate as well as liquidity (that is, free access to international capital). To achieve these goals it must either establish a currency board or join a monetary union. That, in turn, means giving up the policy independence associated with a flexible exchange rate. In a world of freely mobile capital, fixed, but adjustable, exchange rate pegs are unsustainable, because they would immediately be tested by currency speculators. The only way a country can maintain confidence (currency stability) and adjustment (the ability to run an independent macroeconomic policy) is by restricting capital flows. That was the combination chosen by policymakers under the original Bretton

Woods regime. For the first 25 years after the Bretton Woods agreement, the global financial architecture was based on a system of fixed exchange rates and strict capital controls.

Figure 1: Open Economy Trilemma



Source: Krugman (1998).

During the 1960s, however, private investors gradually began to evade these capital controls, and international capital movements increased. As capital mobility increased, countries were forced to choose between the ability to maintain macroeconomic policy independence and exchange rate stability. The breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s shows that industrial countries chose to maintain independence by forfeiting fixed exchange rates. Since then, the world's major currencies—the US dollar, the yen, and the European currencies—have all floated. However, in recent years, some European industrial countries have shifted in the opposite direction. They have solved the open economy trilemma by giving up exchange rate flexibility entirely and creating a single currency, the euro.

In developing countries capital flows remained tightly controlled for much longer. However, in the 1980s, and particularly in the 1990s, the trend toward greater capital mobility has spread worldwide. Thus ever more countries face the choice between exchange rate stability and policy independence. Most have moved toward exchange rate flexibility. In 1976, for instance, 86 percent of

developing countries pegged their currency to a single currency (such as the US dollar or the French franc) or to a basket of currencies. Twenty years later only 45 percent of developing countries still had pegged exchange rates.

The Asian financial crisis, as well as recent crises in Brazil, Mexico, and Russia, hit countries with pegged exchange rates and heavy inflows of foreign capital. They were a direct result of the open economy trilemma. Thus at the heart of the debate on improving the international financial architecture is the thorny question of which of the three goals to give up.

PROPOSALS FOR STRENGTHENING THE ARCHITECTURE

Proposals for strengthening the international financial architecture abound. These proposals differ significantly in terms of their nature and scope. Some proposals are radical and demand a total overhaul of the existing structure, some are conservative and relatively easy to implement within the existing structure, some suggest more forceful responses to the crisis from the international community, while others would rely more on the market for crisis resolution. The following section reviews a set of salient proposals.

Controlling Capital Flows

One group of financial reform proposals hopes to solve the open economy trilemma by controlling capital mobility. Some commentators question the very goal of free capital flows, arguing that free trade alone should be the main objective of development and growth policies. They often put forward two arguments to support this view. First, countries can reap the benefits of free trade in goods and services without simultaneously opening up their financial markets to foreign competition. According to this view, capital mobility is an optional extra. Second, several commentators argue that the theoretical benefits of free capital flows, such as increased investment and more efficient use of funds, do not occur in reality, because the efficiency gains that a country reaps from opening up to foreign capital are more than offset by increasing uncertainty and

greater risk of financial crises. Because financial markets are plagued by imperfect information and a tendency to overshoot, they bring developing countries more risks than rewards. Some economists claim that there is no empirical evidence that countries perform better with capital mobility than without.

The *Asian Development Outlook 1999* shows that these arguments sit uneasily with both economic theory and facts. History shows that countries that try to pursue free trade while maintaining capital controls suffer a number of problems as people try to evade the capital controls. Importers, for instance, often overinvoice their shipments to smuggle capital out of the country. As economies develop and become more open, capital controls not only foster corruption, but also restrict the growth of trade.

Increasing global integration increases uncertainty. However, this also occurs as trade is liberalized. Terms of trade shocks—the sudden rise or fall in a key export or import price—are potentially as unsettling as the contagious spread of financial crises. Moreover, the claim that there is no empirical evidence of any measurable impact of capital account liberalization on a country's welfare is overstated, although the empirical work in this area is nascent.

Market integration is an ongoing multilateral process. While analyzing the costs and benefits for a single economy is possible, the ultimate benefits of integration will depend on policies followed by all countries and their evolution over time. While one country might not suffer too much by slowing down or reversing its capital mobility, the negative impact of many countries doing this could be much higher. For all these reasons, reforms of the financial architecture that are based on a broad move away from capital mobility make little sense.

However, this does not imply that all capital account liberalization is good. The record of financial crises, especially in Asia, shows that ill-planned liberalization of capital flows—without the appropriate market reforms—can result in financial instability and imply large economic costs. The Asian crisis showed that when countries open up their capital accounts without effective supervision and regulation of financial intermediaries, they become more vulnerable to crisis, because the access to foreign capital magnifies the weaknesses and distortions of the domestic financial system.

This suggests that financial liberalization must be carefully sequenced. A number of architectural reform proposals are designed to assist that process. Some concentrate on improving market regulation, bank supervision, and transparency standards. Others concentrate on minimizing the risks associated with capital flows, focusing on measures to discourage short-term borrowing in foreign currency, which is widely regarded as the most dangerous form of foreign capital.

The goal is not to proscribe international financial transactions, but simply to increase their relative cost. This can be done in a number of ways. The most widely supported is to tax foreign borrowing. Chile is the most well-known example of this approach. Until 1998, any company that borrowed abroad had to place 30 percent of the proceeds at the central bank for one year. This unremunerated reserve requirement was the equivalent of a hefty tax on short-term borrowing. Over a longer-term horizon it became much less punitive. In addition, only Chilean companies with a credit rating equivalent to that of the sovereign government could borrow abroad. Alternative ways to discourage short-term borrowing include placing limits on open foreign currency positions by domestic banks and instituting high-risks weights in the capital requirements for foreign currency loans to domestic firms.

These proposals raise a number of questions. First, should the rules apply only to banks or also to the broad corporate sector? Banks are clearly the most vulnerable institutions, but a regulation narrowly focused on banks might simply shift the foreign borrowing to firms. Second, how can such rules be effective in a financial system that lacks adequate supervision and regulation? Third, how can such prudential regulations be implemented without jeopardizing a country's broad commitment to liberalization? Finally, and most important, do they work? Evidence from Chile suggests that the main effect of the controls was not on the level of incoming flows, but on their distribution across assets of different maturities. In other words, while overall capital inflows were not affected, short-term inflows were effectively discouraged (Valdes-Prieto and Soto 1997).

While prudential controls on capital inflows may help prevent a crisis, they are not much use once a crisis occurs. However, some commentators suggest that different capital controls—this time, con-

trols on outflows—may be an important component of crisis resolution. Imposing controls on capital outflows allows policymakers to sever the links between domestic interest rates and exchange rates. Thus they can lower interest rates and stimulate the domestic economy without incurring the cost of a currency devaluation. While capital controls themselves do not solve the fundamental economic problems underlying a currency crisis, their proponents argue that they can give policymakers time to address the relevant reform issues.

Such a strategy carries considerable risks. First, there is the risk of a strongly negative market reaction. Once a country resorts to controls on capital outflows, investors will worry that politicians could introduce them again. They will therefore demand higher returns to invest in that country again. Worse, the introduction of capital outflow controls could unsettle markets more broadly and have negative consequences for the market access of other developing countries.

Second, capital outflow controls are not often implemented and managed by benevolent governments, but by partisan policymakers in a distorted environment. They create the incentives for corruption and reduce the pressure for politicians to introduce politically unpopular structural reforms. If "temporary" controls on capital outflows remain in place for long, the negative implications for a country quickly rise. For all these reasons, proposals to sanction the broad use of capital outflow controls are unlikely to find much support among international financial architects.

Improving Regulatory Standards

One of the main causes of the Asian financial crisis was poor regulation and supervision of financial institutions. Hence it is not surprising that much of the effort to improve the international financial architecture has concentrated on finding ways to improve international standards of financial regulation and supervision.

Two of the G22 working group reports were concerned with these issues: one concentrated on transparency and accountability (G22 1998b), the other on strengthening financial systems (G22 1998a). The report on transparency contained a variety of

suggestions ranging from the uncontroversial (for instance, that private firms should adhere to national accounting standards) to the ambitious (that wide-ranging data on the international exposure of financial institutions and firms should be compiled and published). The report on strengthening financial systems enumerated major weaknesses in many domestic financial sectors, such as inadequate risk management, faulty deposit insurance schemes, and mismatched assets and liabilities. It found that international consensus existed in many areas of banking supervision and securities regulation, but that in some areas best practices and standards needed to be defined, and noted that standards should be defined in a collaborative manner so that both industrial and developing countries have a voice.

The Basle Capital Accords are widely regarded as a model for international supervisory standards. Although originally agreed on by the G10, the Basle standards for minimum capital adequacy for banks are now widely accepted. To ensure that banks are adequately capitalized, the Basle standards are specified against banks' risk-adjusted assets rather than their total assets. The Basle Capital Accords provide a framework for classifying assets according to their risk categories, specifying different risk weights for different risk categories, and calculating risk-adjusted assets. Since 1997 they have been supplemented by a broader set of core principles of banking supervision.

One way to encourage countries to adopt such standards is through IMF surveillance. The G22 working committees, for instance, recommended that the IMF issue a transparency report along with its regular Article IV economic assessment of member countries. Another approach is to improve coordination between regulatory bodies, or even to introduce a system of peer review, whereby national regulators could supervise each other. Improved regional surveillance would be another option. In this connection, the Asian Development Bank has established a Regional Economic Monitoring Unit to support the recently initiated regional surveillance activities of the ASEAN.

Another set of reform proposals focuses on improving existing regulatory standards. Some suggestions concentrate on tightening the rules on foreign borrowing in developing countries. Others focus

on changing the incentives lending banks face, in particular, by updating the Basle capital adequacy accords. Regulating lending banks has two positive effects. The first is realism: regulators of borrowing banks (in developing countries) are generally less sophisticated than those of lending banks (in industrial countries). The second effect is that better regulation might improve the incentives facing lending banks.

The existing Basle capital standards contain several perverse incentives. For instance, risk weightings for short-term loans are considerably lower than for long-term loans, which gives lending banks a clear incentive to supply short-term rather than long-term loans to emerging markets. The ongoing revision of the Basle capital standards may well contain changes to these risk weightings. The Basle supervisors are also considering the issue of banks' internal risk assessment for regulatory purposes. As the banks themselves should have the strongest incentive to act with prudence, some economists and policymakers have argued that the greater use of banks' own methods of risk assessment (value-at-risk models) can be extremely useful for this purpose. Also under discussion in this regard is the need for regulatory purposes of increased reliance on market discipline through the mandatory issuance of subordinated debt, that is, debt that has a "junior" claim on a firm's assets in the event of bankruptcy.

Compared with banking regulation, the problem of regulatory standards becomes much more severe when it comes to auditing and accounting, insolvency codes, and corporate governance. In these areas, a number of private sector bodies are active. The International Accounting Standards Committee, a committee with members from more than 100 countries, formulates international accounting standards. The International Federation of Accounts and the International Organization of Supreme Audit Institutions formulates auditing standards and issues auditing guidelines. Committee J of the International Bar Association has been concerned with bankruptcy laws and insolvency guides. The International Corporate Governance Network deals with issues of corporate governance. While all these organizations have done much useful work, much remains to be accomplished in improving standards in these areas.

To improve regulatory standards in the financial and corporate sectors internationally, some have suggested that the international financial organizations should work in harmony with these private sector entities. The international financial organizations should recognize these standards, urge adoption by their memberships, and monitor compliance. This decentralized approach to regulatory reform has much to recommend it.

More radical regulatory reform ideas include the creation of global regulatory institutions. Proposals include a world financial authority that would be the equivalent of the World Trade Organization for financial institutions and a board of overseers of international financial markets. In each case, given that the goal is to create a global supervisor and regulator consistent with global capital markets, countries would have to surrender substantial amounts of national sovereignty. That requirement renders these ideas unrealistic, at least for the moment.

Finally, in this regard, a recent institutional innovation of the G7 has been the creation of the Financial Stability Forum. This forum, which will bring together central bankers, finance ministers, financial regulators, and representatives of multilateral organizations, has an ambitious mission, that is, to assess the issues and vulnerabilities affecting the global financial system and to identify and oversee the actions needed to address them. It is too early to say what role the forum will play in the evolving international financial architecture. However, if it can create a mechanism for improving information sharing, surveillance of and agreements on standards, codes of conduct, and transparency requirements, then it would significantly increase the efficiency of global financial markets and reduce systemic risks. To achieve this objective successfully, the forum will need to expand its membership to emerging economies.

Rethinking Exchange Rate Regimes

The Asian crisis has shown that pegged, but adjustable, exchange rates are difficult to sustain in a world of increasing capital mobility. Sooner or later they are likely to be tested by a speculative attack, forcing—at the very least—high interest rates and budget cuts. The Asian crisis has also reinforced another traditional argu-

ment against fixed, but adjustable, exchange rates: by creating an illusion of permanent currency stability, they reinforce the incentive for financial institutions and firms to borrow from abroad without hedging.

Given these problems, the consensus now among economists is that only the extremes of exchange rate management are likely to succeed. Today's conventional wisdom suggests that countries must either rigidly and irrevocably tie their currency to another by adopting a currency board or entering into a currency union, or they must allow their currency to float.

Three related arguments support flexible exchange rate regimes. First, countries with floating currencies are less likely to suffer sudden crises of investor confidence. By definition, they will not waste precious reserves defending an exchange rate peg. Empirical studies confirm that serious currency crises are generally associated with the collapse of a fixed exchange rate regime. On average, countries that see a sudden depreciation of a floating currency suffer less macroeconomic distress.

Second, a flexible exchange rate regime allows the government more room to act as a lender of last resort to the financial sector. Countries committed to defending a currency peg cannot provide domestic liquidity freely without risking a loss of reserves. Countries with a flexible rate need not worry about losing reserves, because the exchange rate will simply depreciate as more domestic liquidity is created. This flexibility does not mean that countries with a flexible exchange rate can prevent financial crises generated, for instance, by large capital outflows. In fact, if the burden of external debt is high, the scope for increasing liquidity domestically may be limited.

Third, a flexible exchange rate allows a country more autonomy in regard to its macroeconomic policy. This is the classic argument in favor of floating rates (see the earlier discussion of the open economy trilemma). However, exaggerating this benefit, especially for developing countries, is easy. A developing country with significant policy autonomy may have trouble gaining credibility in international financial markets. Too often in the past governments have used their discretion to pursue imprudent, inflationary policies. Countries with floating exchange rates often have to keep interest

rates high to maintain investors' confidence. Mexico's experience in mid-1998 makes the point. The peso fell by 20 percent in response to turmoil in Asia and Russia, yet Mexican interest rates were considerably higher than those in Argentina, a country with an extremely tough currency board.

The choice of currency regime will depend on a country's size, history, and geographical location. In Europe, for instance, it is likely that more countries will ultimately adopt the euro. In Latin America, Argentine policymakers are talking seriously of dollarization. In Asia, the future is much more uncertain, and the political and practical hurdles to any regional currency union are high. Yet the costs of excessive volatility and competitive devaluation are an important concern in Asia's highly open economies.

Some economists have recently advocated the need for strong coordination of exchange rates among Asian currencies. According to this view, recovery from this crisis could be strongly facilitated if the crisis-affected countries could re-adopt a dollar exchange rate target, as they did before mid-1997. While exchange rate policy does have international spillover effects, it does not mean that explicit coordination is required to achieve stability. In addition, the root causes of the current crisis were largely domestic and structural. Therefore any attempt at international exchange rate coordination without first addressing those structural problems will be based on shaky foundations and is likely to be counterproductive.

Finally, the crisis-affected countries differ significantly in terms of their history of exchange rate regimes. Before the crisis hit, exchange rate regimes in Asia were not identical. Indonesia and Korea had adopted a more flexible system (close to a crawling peg) than Malaysia and Thailand. Although the postcrisis period has seen a general movement toward greater exchange rate flexibility, the diversity in exchange rate regimes continues. This suggests that Asian economies are unlikely to see complete uniformity in exchange rate management soon.

Creating an International Lender of Last Resort

A number of reform proposals focus on preventing contagion in international financial markets by creating an international

lender of last resort. The argument in favor of an international lender of last resort is based on an analogy with the role central banks play in national economies. When a banking panic hits a domestic financial system, the central bank can limit contagion by providing liquidity to the system. In a world of integrated capital markets, many argue that a similar institution is needed at the international level. By providing limited liquidity in return for policy conditionality, the IMF already plays a similar, if highly circumscribed, role. Most advocates of an international lender of last resort suggest that the IMF should play this role.

However, the proposal to create an international lender of last resort is plagued with conceptual and practical difficulties. Conceptually, scholars do not agree on exactly what a lender of last resort does. The classic definition stems from Bagehot (1873): the lender of last resort should lend freely, at a penalty rate, on good collateral in a time of financial panic. Thus the lender of last resort must be able to distinguish between healthy and insolvent institutions, intervening only to stop unwarranted panics and leaving insolvent institutions to fail.

Extending these conditions from banks to countries and from national authorities to international institutions is extremely difficult. The first problem is that of distinguishing between illiquidity and insolvency. An international lender of last resort should provide limitless liquidity in the case of the former, and demand restructuring and adjustment in the case of the latter, but as the Asian crisis highlighted, distinguishing between the two is extremely difficult.

The second problem is that of moral hazard. National central banks put in place prudential regulations on domestic financial institutions to limit reckless behavior. They also retain the power to close or merge insolvent or weak financial institutions. Neither capacity exists at the international level. As yet, no binding global rules of financial behavior exist, and the IMF certainly cannot close down a recalcitrant country.

The final issue is that of resources. If necessary, a domestic central bank can provide limitless liquidity simply by printing money (unless it is constrained by a fixed exchange rate regime). The IMF has no capacity to issue fiat money. Its resources are limited, and despite the recent capital increase and introduction of the

New Arrangements to Borrow (an emergency credit line from donor countries to the IMF), they are insufficient to make it a credible lender of last resort. To fulfill this role the IMF would need a substantial increase in its resources. Whether this would be politically feasible is unclear.

Some observers suggest that only countries that meet a stringent set of requirements, especially as concerns their banking systems, should have access to IMF funds (Calomiris 1998). To those countries that fulfill the requirements, the IMF should lend without policy conditionality, but should demand collateral in the form of government bonds. One academic suggests that only countries that have complied with an agreed risk control strategy should qualify for IMF funds (Dornbusch 1998). These suggestions suffer from the problem that few countries would fulfill the requirements. Given the contagious nature of financial crises, it is unlikely that large countries would be left unaided even if they failed to meet the criteria. Moreover, by announcing that a country no longer fulfilled the criteria for assistance, the IMF might actually precipitate a crisis. More modest proposals suggest that this risk can be reduced by charging countries with lower financial standards higher interest rates for assistance (Fischer 1999).

A proposal put forward by the United States in September 1998, and subsequently endorsed by the G7, moves the IMF cautiously in the direction of being a lender of last resort. The goal is to set up a contingency financing facility, where countries in good economic health can set up a precautionary credit line with the IMF to reduce the chances of being hit by financial contagion. Although the idea is still under discussion, the difficulty of distinguishing between unwarranted panic and fundamental economic problems will make this facility extremely difficult to implement.

Finally, Japan has recently proposed the creation of regional currency support mechanisms to complement the role and function of the IMF. The mechanisms are institutions that would provide liquidity in times of financial crisis. These mechanisms, which could be established in Asia, the Western Hemisphere, and Eastern Europe, could be regionally funded by countries that are economically interlinked with each other by trade, investment, and so on, and are engaged in policy dialogue with each other. Nonregional countries

with political and economic interests in the region could also participate. This idea of regional currency support mechanisms, which found an earlier articulation in the proposal for establishing an Asian Monetary Fund (Box 3), is in the initial stage of discussion and development.

"Bailing In" the Private Sector

Another popular goal among the architects of international financial reform is that of bailing in the private sector. The idea is to minimize moral hazard and spread the burden of financial crisis by ensuring that private investors and banks bear some of the cost.

One approach that Argentina and Mexico have successfully pioneered is to set up private sector credit lines before a crisis. Argentina has negotiated $6.7 billion worth of repurchase arrangements with international banks. Against the collateral of domestic bonds, these arrangements give Argentina access to capital in the event of a financial crisis. They are, in effect, a limited form of private lender of last resort. Such arrangements have considerable potential, particularly if multilateral development banks guaranteed some portion of the risk involved, and thereby encouraged more private banks to participate in such schemes.

More controversial are proposals to forcibly bail in private investors once a crisis has struck. One proposal, advocated by the G22, is to encourage "lending into arrears" by the IMF. Since the 1980s the IMF has been able, in certain circumstances, to lend to a country that was in arrears on its commercial bank debt. Now this idea has been extended to countries that are in default to other private creditors, including bondholders. Provided that the country is willing to undertake strong policy adjustment and is making good-faith efforts to work with creditors to solve its financial problems, the IMF can lend to the country. This effectively sanctions a default. The goal behind this approach is to encourage recalcitrant creditors to negotiate, and thereby to promote orderly and responsible debt restructuring rather than chaotic default.

The G22 working group also recommended that bond contracts be modified to facilitate restructuring. By including so-called collective action clauses, such as the collective representation of

Box 3: Is There a Case for an Asian Monetary Fund?

In September 1997, before the full international implications of the Asian crisis had become apparent, Japan proposed the establishment of a new Asian Monetary Fund (AMF). Far from undermining the role of the IMF, the AMF could act as a regional complement to the IMF in the way that, for example, the ADB complements the work of the World Bank. The sources of this complementarity are essentially fourfold:

- The Asian crisis has demonstrated the need for an early warning system. While the problems of one or two of the Asian countries were anticipated before July 1997, the extent of the meltdown and contagion took international institutions by surprise. Thus ways to provide forewarning of impending problems are needed, and could be most effectively undertaken at the regional level, through the AMF, as the participating countries would have detailed knowledge of problems in their area.
- Once a problem has been identified in a country, the government of that country needs to address it speedily. Given the damage that contagion can produce, regional peer pressure through the AMF could be an effective method of ensuring that this is done.
- Given its informational advantage and regional location, an AMF would likely be more receptive—hence geared to early action—to a regional crisis than a global institution.
- The resources the IMF initially made available were insufficient to head off the Asian crisis and additional packages had to be hastily assembled as the crisis unfolded. The AMF could provide such a line of defense on a permanent basis.

The initial proposal for the AMF suggested funding of $100 billion, half of which was to come from Japan and the remainder from PRC; Hong Kong, China; Singapore; and Taipei,China. The argument was that such a sum would provide sufficient liquidity to forestall speculative attacks on the region's cur-

creditors, designating a trustee to speak for creditors, binding majority decisions, and formulas for sharing the costs of workouts in all sovereign bond offerings, involving the private sector in the resolution of financial crises would be easier. While an orderly workout is clearly superior to a disorderly one, the risk involved in changing bond contracts is that the market for such bonds will shrink and the cost of funds will rise.

More radical proposals along similar lines include imposing "haircuts" (mandatory losses) on investors if they flee during a financial crisis. One proposal suggests a mandatory debt rollover option with a penalty on all foreign currency lending (Buiter and

rencies. Unlike the IMF's loans, the AMF's assistance would not come with economic conditions attached.

Despite strong support from Malaysia, the proposal did not get far. Only two months after it had first been suggested, it was turned down at the fifth Asia-Pacific Economic Cooperation meeting in Manila. One objection was the fear that financial support without any conditions attached would raise the risk of moral hazard. Another risk was lack of coordination and of potential conflict with the IMF.

Nevertheless, during the IMF/World Bank Annual Meeting in 1998, Japan returned with a more modest revised proposal, the Miyazawa Plan. This proposed a $30 billion package for the region. Half of the money was to facilitate short-term trade financing, the other half was to promote economic recovery through medium and long-term projects. Japan suggested that the Japan Export-Import Bank, the World Bank, and the ADB could all participate in the undertaking. In addition to the $30 billion assistance plan, at the October 1998 Asia-Pacific Economic Cooperation meeting, Japan and the United States, with the support of the ADB and the World Bank, launched the Asian Growth and Recovery Initiative that envisages a package of $10 billion for the crisis-affected countries.

In the face of increasing instability of global financial markets, the need for regional institutions to dampen financial contagion is being increasingly acknowledged. Western Europe has a comprehensive regional financial infrastructure in the form of the Economic and Monetary Union. However, no such institutions exist in Asia, in the Western Hemisphere, and in Eastern Europe. Along with similar institutions for the Western Hemisphere and Eastern Europe, the AMF could play a potentially important role as a complement to the IMF in providing funds to crisis-affected countries and developing an early warning system. The implementation of such regional institutions as the AMF as part of the newly emerging financial architecture will help both to enhance the efficiency of global financial markets and to minimize their systemic risk.

Sibert 1998). This option would entitle the borrower to extend or roll over the debt at maturity for a specified period, say three or six months, at a penalty rate. The penalty would have to be big enough to ensure that the borrower would not want to exercise the rollover option under orderly market conditions. If crisis conditions still prevailed when the rollover period expired, the option could be exercised again at an even higher penalty. This proposal would only be useful when otherwise solvent borrowers are unable to roll over their foreign currency debt because of a liquidity crisis or credit crunch. It only helps when a country is solvent, willing to pay, but prevented from doing so because international financial and credit

markets are temporarily closed to it. Given the difficulty of distinguishing between insolvency and illiquidity, it is not clear that a market for such options would emerge. This proposal, too, might simply raise the cost of capital for borrowing countries.

The most radical ideas for bailing in the private sector focus on creating an international bankruptcy court. Just as domestic bankruptcy courts can prevent creditor grab-races; decide on a hierarchy of claimants; and allow an insolvent, but viable, firm access to new financing, so some commentators suggest there should be an international bankruptcy court to restructure countries' debts. This idea stands little chance of being implemented. First, it would demand a huge surrender of national sovereignty. Second, national bankruptcy codes differ enormously, and reaching international agreement on a single code is highly unlikely.

TOWARD AN AGENDA OF MINIMUM NECESSARY REFORMS

Massachusetts Institute of Technology economist Rudiger Dornbusch has noted that in the aftermath of every crisis, whether a war or a currency collapse, a soul-searching effort to build a better world ensues. This is a great occasion for bad ideas or impractical ones (Dornbusch 1998). The Asian financial crisis is just such an occasion: it has prompted scores of proposals for a new international financial architecture.

Many of these ideas are interesting, yet impractical. Many are innovative, but often inconsistent with each other. The reason is that different reformers choose different combinations of national sovereignty, financial market regulation and support, and capital mobility. Given these incompatible goals, international policymakers are unlikely to agree on radical changes to today's financial architecture. Nonetheless, effective reforms can take place within the existing institutional system. These include the following:

- *Negotiating minimum international standards of financial practice.* Despite considerable progress at creating international norms, auditing and accounting practices still vary considerably across countries. This makes it difficult for lenders to gauge the financial conditions of borrower banks and corporations. Differences in cor-

porate governance practices, investor protection laws, and laws relating to insider trading in securities markets also make international capital markets less transparent and more dangerous than they need be. While individual countries should implement reforms in these areas as they deem appropriate, minimum international standards would help prevent national problems spilling over to the international level.

- *Introducing prudent regulation of capital accounts.* While developing countries should aim for integration into the international financial system, this should not imply a reckless rush to capital account convertibility. The gradual and cautious removal of capital controls may be appropriate for countries whose domestic capital markets are underdeveloped and whose capacity to regulate excessive risk taking by domestic institutions is limited. For many developing countries, Chilean-style taxes on capital flows may be helpful.
- *Reforming exchange rate regimes.* Large unexpected swings in the exchange rate can bring serious financial distress to domestic banks and corporations with unhedged debt exposure. This problem can be minimized in two ways. First, a floating exchange rate will induce banks and corporations to hedge their foreign currency debt. Second, a currency board or currency union will permanently eliminate unexpected currency fluctuations. International financial institutions, particularly the IMF, can push the agenda of an appropriate exchange rate regime without any fundamental institutional change.
- *Creating the framework for an orderly restructuring of problem debts.* Debt restructuring today is a difficult, protracted process. Modest changes—including clauses for majority voting and the provision of a trustee to represent and coordinate creditors—could easily be introduced. If industrial countries included such provisions in their bond contracts, they could become standard practice, then developing countries would not incur a price penalty when they introduced them.
- *Encouraging private sector credit lines.* Given the IMF's limited resources and the conceptual difficulties surrounding the notion of an official international lender of last resort, limited credit lines with the private sector appear promising. Argentina's contingency

finance arrangements with private banks seem to have served it well. With multilateral guarantees this approach might prove useful for more countries.

These modest proposals do not constitute a new Bretton Woods. They do not call for a massive new bureaucracy nor a huge investment of public funds. However, they could help to reduce the risk of financial crises and reduce their severity should they occur. That alone would bolster, rather than hinder, the process of financial integration from which both industrial and developing countries have so much to gain.

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