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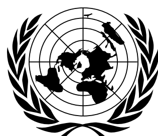
Global trends and prospects

Financial architecture



UNITED NATIONS

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.

> 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.

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.

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.

> "… 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 … the new set of external disciplines come hand-in-hand with a particular model of economic development of doubtful worth …"

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.

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.

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.

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).

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, 2000: 15).

Indeed, as noted in chapter V, discussions on exchange rates have concentrated on the kind of regimes that developing countries would need to adopt in order to attain greater stability. The mainstream advice is to choose between free floating or locking into a reserve currency through currency boards or dollarization (the "hard" pegs), thus opting for one of the two "corner" solutions, as opposed to intermediate regimes of adjustable or soft pegs. Increasingly questions are being 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 mechanisms, regimes for capital movements, and various facilities designed to provide payments support to individual countries and regional lender-of-last-resort services. However, applying this experience to arrangements among developing countries poses certain difficulties, particularly with respect to the exchange rate regime to be pursued vis-à-vis reserve currencies and access to international liquidity, issues of special importance under conditions of intraregional contagion. Regional monetary arrangements among emerging markets

Governance in macroeconomic and financial policies lacks the kind of multilateral disciplines that exist for international trade.

There is now a growing interest in East Asia and some countries of South America in regionalization as a means of providing a collective defence mechanism against systemic failures and instability.

could thus be greatly facilitated if they involved also the major reserve-currency countries. In this respect, the recent initiatives taken by ASEAN+3 (see chapter V, box 5.1) constitute an important step along what may prove to be a long and difficult path to closer regional monetary integration.

D. Orderly workout mechanisms for international debt

A third major area of reform concerns orderly workout mechanisms for international debt. Such mechanisms have gained added importance in view of shortcomings in global arrangements for the prevention of financial crises. The prospect that crises will continue to occur, even with increasing frequency and severity, poses a dilemma for the international community. Once a crisis occurs, it is difficult to avoid widespread messy defaults on external liabilities in the absence of bailouts, with attendant consequences for international financial stability. But bailouts are becoming increasingly problematic. Not only do they create moral hazard for lenders, but also they shift the burden onto debtor countries and their taxpayers, who ultimately pay off the official debt. Furthermore, the funds required have been getting larger and more difficult to raise. For these reasons, one of the main issues in the reform agenda is how to “involve” or “bail in” the private sector in crisis management and resolution so as to redress the balance of burden-sharing between official and private creditors as well as between debtor and creditor countries.

One way out of this dilemma would be recourse to the principles of orderly debt workouts along the lines of chapter 11 of the United States Bankruptcy Code, a proposal first put forward by the UNCTAD secretariat (in *TDR 1986*) in the context of the debt crisis of the 1980s, and more recently re-examined by it (in *TDR 1998*) in relation to emerging-market crises. Application of these principles would be especially relevant to international currency and debt crises resulting from liquidity problems because they are designed primarily to address financial restructuring rather than liquidation. They allow a temporary standstill on debt servicing based on recognition that a grab race for assets by creditors is detrimental to the debtor as well as to the creditors themselves as a group. They provide the debtor with access to the working capital needed to carry out its operations while granting seniority status to new debt. Finally, they involve reorganization of the assets and liabilities of the debtor, including extension of maturities and, where needed, debt-equity conversion and debt write-off.

One way to implement these principles is to create an international bankruptcy court in order to apply an international version of chapter 11 (or, as appropriate, chapter 9) drawn up in the form of an international treaty ratified by all members of the United Nations (Raffer, 1990). However, full-fledged international bankruptcy procedures are not necessary to ensure an orderly workout for international debt. Another option would be to establish a framework for the application to international debtors of key insolvency principles, namely debt standstill and lending into arrears (i.e. lending to a debtor in arrears to its creditor). Since prompt action is necessary to ward off speculative attacks and financial panic, the decision for standstill should rest with the debtor country and then be sanctioned by an international body, so as to provide the debtor with insolvency protection in the national courts of creditor countries. Restructuring of private debt could then be left to national bankruptcy procedures, while for sovereign debt direct negotiations with creditors appear to be the only feasible solution.

As discussed in chapter VI, while it has been increasingly accepted that market discipline will only work if creditors bear the consequences of the risks they take, the international community has not been able to reach an agreement on how to involve the private sector in crisis management and resolution. Even though a framework such as the one described above has found considerable support among many industrial countries, there is strong opposition from some major powers, and from participants in private markets, to mandatory mechanisms for "binding in" and "bailing in" the private sector. Considering that such mechanisms would alter the balance of negotiating strength between debtors and creditors and create moral hazard for debtors, they advocate, instead, voluntary and contractual arrangements between debtors and creditors to facilitate debt workouts, such as the insertion of collective action clauses in bond contracts. Moreover, a number of middle-income countries, particularly those with a relatively high degree of dependence on financial inflows, are opposed to both mandatory standstills and the inclusion of collective action clauses in bond contracts for fear that their access to international financial markets would be impaired.

> The IMF Board recognized that, "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally". However, there is no agreement over empowering the IMF to impose a stay on creditor litigation in order to provide statutory protection to debtors imposing temporary standstills.

The discussions in the IMF Executive Board on this issue emphasized the catalytic role of the Fund in involving the private sector and that, if the latter did not respond, the debtor country should seek agreement with its creditors on a voluntary standstill. The Board recognized that, "in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally". However, there is no agreement over empowering the IMF, through an amendment of its Articles of Agreement, to impose a stay on creditor litigation in order to provide statutory protection to debtors imposing temporary standstills. While it is generally accepted that the Fund may signal its acceptance of a unilateral standstill by lending into arrears, no explicit guidelines have been established on when and how such support would be provided, thus leaving considerable discretion to the Fund and its major shareholders regarding the modalities of its intervention in financial crises in emerging markets.

As in other areas, the reform process has thus been unable to establish an appropriate international framework for involving the private sector in the management and resolution of financial crises, passing the buck again to debtor countries. True enough, contractual arrangements, such as collective action clauses in bond contracts and call options in interbank credit lines, can provide considerable relief for countries facing debt servicing difficulties, and the misgivings that such arrangements may impede access to capital markets may be misplaced. But these are not matters for consideration in the reform of the international financial architecture, unless global mechanisms are introduced to facilitate such arrangements. There is also resistance to introducing automatic rollover and collective action clauses in international debt contracts based on an international mandate. Furthermore, certain features of external debt of developing countries, including wide dispersion of creditors and debtors and the existence of a large variety of debt contracts, governed by different laws, render it extremely difficult to rely on voluntary mechanisms for securing rapid debt standstills and rollovers. Without a statutory protection of debtors, negotiations with creditors for restructuring loans cannot be expected to result in equitable burden sharing. Indeed, in recent examples of negotiated settlements the creditors have not borne the consequences of the risk they had taken; rather, they have forced the developing country governments to assume responsibility for the private debt and accept a simple maturity extension at penalty rates.

E. Reform of the IMF

Naturally, reforms and recent initiatives in the areas discussed above generally imply significant changes in the mandate and policies of the IMF, particularly with respect to bilateral and multilateral surveillance, conditionality and the provision of international liquidity. As noted above, the Fund is closely involved in setting codes and standards for macroeconomic and financial policies and monitoring compliance, and effective multilateral surveillance is a prerequisite for a stable system of exchange rates. Private sector involvement in crisis management and resolution also crucially depends on IMF lending policies, as well as on its support and sanctioning of standstills and capital and exchange controls. Consequently, the reform of the international financial architecture presupposes a reform of the IMF.

1. Surveillance and conditionality

As discussed in *TDR 1998*, asymmetries in IMF surveillance, in the aftermath of the East Asian crisis, along with excessive conditionality attached to IMF lending, were widely considered to be two of the principal areas deserving attention in the reform of the international financial architecture. However, the recent approach to reform has resulted in increased asymmetries in surveillance and in enhanced conditionality, since it has focused primarily on policy and institutional shortcomings in debtor countries.

As already noted, surveillance has not been successful in ensuring stable and appropriately aligned exchange rates among the three major reserve currencies. Nor has it been able to protect weaker and smaller economies against adverse impulses originating from monetary and financial policies in the major industrial countries. It is true that the need for stronger IMF surveillance in response to conditions produced by greater global financial integration and recurrent crises was recognized by the Interim Committee in April 1998, when it agreed that the Fund "should intensify its surveillance of financial sector issues and capital flows, giving particular attention to policy interdependence and risks of contagion, and ensure that it is fully aware of market views and perspectives" (IMF Interim Committee Communiqué of 16 April 1998). However, despite the reference to interdependence and contagion, these proposals have not so far been effectively extended to cover weaknesses arising from the lack of balance in existing procedures.

Rather, there has been an intensification of IMF surveillance and conditionality as a result of their extension to financial sector issues in debtor countries, in accordance with the diagnosis that this is where the main problem lies. As noted above, new codes and standards are likely to result in enhanced conditionality, particularly for the use of new facilities, including contingency financing, for overcoming financial crises. Quite apart from whether the result could be unnecessary interference with the proper jurisdiction of a sovereign government, as some commentators believed it was in the Republic of Korea (Feld-

stein, 1998), there is also the potential problem that the type of measures and institutions promoted may not be the appropriate ones:

> An unappreciated irony in this is that conditionality on developing countries is being ratcheted up at precisely the moment when our comprehension of how the world economy works and what small countries need to do to prosper within it has been revealed to be sorely lacking. (Rodrik, 1999: 2)

The International Monetary and Financial Committee (IMFC, formerly the Interim Committee), recognizing the need to streamline IMF conditionality, has urged "the Executive Board to take forward its review of all aspects of policy conditionality associated with Fund financing in order to ensure that, while not weakening that conditionality, it focuses on the most essential issues".[6] For his part, the Fund's new Managing Director, Horst Köhler, has likewise concluded that:

> To strengthen its efficiency and legitimacy, the Fund needs to refocus. The Fund's focus must clearly be to promote macroeconomic stability as an essential condition for sustained growth. To pursue this objective, the Fund has to concentrate on fostering sound monetary, fiscal and exchange rate policies, along with their institutional underpinning and closely related structural reforms. … I trust that ownership is promoted when the Fund's conditionality focuses in content and timing predominantly on what is crucial for the achievement of macroeconomic stability and growth. Less can be more if it helps to break the ground for sustained process of adjustment and growth.[7]

Perhaps it is too early to judge how far in practice this refocusing has been pursued, but it is notable that the recent Fund programmes in Turkey and Argentina show no significant tendency to depart from past practice (see chapter II, boxes 2.1 and 2.2). They stipulate a wide range of policy actions not only in the purview of other international organizations, such as WTO and the development banks, but also of national economic and social development strategies, including actions relating to privatization and deregulation, agricultural support, social security and pension systems, industrial and competition policy, and trade policy.

2. Liquidity provision and lender-of-last-resort financing

The other major area of reform concerns the provision of adequate liquidity. A consensus has emerged over the past decade that the Fund should provide international liquidity not only to countries facing payments difficulties on current account but also to those facing crises on capital account. Two main facilities have been established for this purpose: a Supplemental Reserve Facility (SRF) for countries already facing payments difficulties, and a Contingency Credit Line (CCL) to provide a precautionary line of defence against international financial contagion (see chapter VI, box 6.3). While there are difficulties regarding the terms and conditions attached to such facilities, the real issue is whether and to what extent provision of such financing conflicts with, or complements the objective of, involving private creditors and investors in the management and resolution of emerging-market crises.

In several debtor countries, governments appear to favour unlimited liquidity support, regardless of the terms and conditions and the burden that may eventually be placed on the country's tax payers by international rescue operations. This attitude is consistent with their aversion to imposing temporary payments standstills and capital and exchange controls at times of crisis. On the other hand, while there is no consensus in the IMF Board on mandatory arrangements for involving the private sector, there is now a growing emphasis on making official assistance conditional on private sector participation. However, no formal limits have been set for access to Fund resources beyond which such participation would be required. As discussed in chapter VI, absence of explicit access limits as well as of mandatory standstill mechanisms may render it extremely difficult to secure private sector involvement, forcing the Fund to engage in large-scale interventions.

Indeed, since the main objective of large-scale contingency or crisis financing would be to allow debtor countries to remain current on payments to their creditors, it is difficult to see how this could be reconciled with a meaningful private sector involvement in crisis resolution and burden sharing. Consequently, a credible and ef-

fective strategy for involving the private sector should combine temporary standstills with strict limits on access to Fund resources. While there is growing agreement on the need to limit crisis lending, it is also suggested that there may be a need for exceptionally large contingency financing when the crisis appears to be "systemic". In practice, such an approach could result in differentiation among debtor countries: those for which the crisis is considered "systemic" would be eligible for considerable liquidity support without any prior condition for private sector participation, as in recent operations in Argentina and Turkey; those where the crisis is not so considered would face strict limits and would be encouraged to involve the private sector through default, as seems to have been the case for Ecuador and Pakistan.

> Since the main objective of large-scale contingency or crisis financing would be to allow debtor countries to remain current on payments to their creditors, it is difficult to see how this could be reconciled with a meaningful private sector involvement in crisis resolution and burden sharing.

There are proposals to go further and allow the IMF to act as, or to transform that institution into, an international lender of last resort for emerging markets. Proposals of this nature have been put forward by the Deputy Managing Director of the Fund (Fischer, 1999) and, in the broader context of reforming the international financial institutions, by the International Financial Institutions Advisory Commission (Meltzer Commission). Indeed, the idea has received much greater sympathy than any other proposal for institutional changes at the global level, from among people with sharply different views about the reform of the IMF and situated at opposite ends of the political spectrum, although certain aspects of the Meltzer Commission's recommendations are highly contentious.[8] The key suggestion is that countries meeting certain *ex ante* conditions for solvency should be eligible for lender-of-last-resort financing. In the proposal by the Meltzer Commission, access to liquidity would be automatic for countries meeting a priori requirements, and no additional conditionality or negotiations would be required. Lending would be limited to a maximum of one year's tax revenue of the borrowing country. This could result in far greater packages than any crisis lending by the IMF so far. The problem of moral hazard would be tackled by conditionality rather than by tighter limits on lending. By contrast, the report does not make any recommendation for involving the private sector, except to suggest that, for the time being, the matter should be left to negotiations between debtors and creditors.

Arrangements of this nature would, however, compound certain problems encountered in the current practice regarding IMF bailouts. Without discretion to create its own liquidity, the Fund would have to rely on major industrial countries to secure the funds needed for such operations. In such circumstances it is highly questionable whether it would really be able to act as an impartial lender of last resort, analogous to a national central bank, since its decisions and resources would depend on the consent of its major shareholders, who are typically creditors of those countries experiencing external financial difficulties. This problem could be partly overcome by authorizing the Fund to issue permanent or reversible SDRs, but attributing such a key role to the SDR would face strong opposition from the same source.

Furthermore, there are also political and technical difficulties regarding the terms of access to such a facility. Financing by a genuine international lender of last resort, which would be unlimited and unconditional except for penalty rates, would require very tight global supervision over borrowers to ensure their solvency, which it would not be easy to reconcile with national sovereignty. Nor would prequalification be compatible with the practice of "constructive ambiguity" that all modern national lenders of resort are said to follow.[9] It would also require the IMF to act as a de facto credit-rating agency. However, it is very difficult to establish generally agreed standards for solvency, and assessments of a given set of economic indicators can vary considerably, as evidenced by differences among private rating agencies (Akyüz and Cornford, 1999: 48). Dis-

agreements in this respect between the developing countries concerned and the Fund staff could lead the countries to opt out and seek alternative arrangements, thereby reducing the effectiveness of the proposed mechanism. Moreover, since it would be necessary constantly to monitor the fulfilment of the preconditions, adjusting them as necessary in response to changes in financial markets or other changes beyond the control of the Government of the recipient country, prequalification would not avoid difficulties in relations between the Fund and the member concerned.

Transforming the Fund into an international lender of last resort would involve a fundamental departure from the underlying premises of the Bretton Woods system, which provided for the use of capital controls to deal with instability. In discussion of such a facility its introduction is frequently linked to concomitant arrangements regarding rights and obligations with respect to international capital transactions, together with a basic commitment to capital-account liberalization. This departure from the Bretton Woods arrangements is particularly notable in the report of the Meltzer Commission, which virtually proposes, inter alia, the discontinuation of all other forms of IMF lending, including those for current account financing. Such a drastic shift in the nature of IMF lending, from current account to capital account financing, would lead to a further segmentation of the Fund's membership, with consequences for its governance and universality. Indeed, as noted by a former United States Treasury Secretary, only a small number of relatively prosperous emerging economies would be eligible for lender-of-last-resort financing.[10]

Moreover, under these proposals, a large majority of developing countries would be excluded from multilateral financing. The Meltzer Commission argued, throughout its discussion of lending policies by both IMF and the World Bank, that current account financing to developing countries should, in principle, be provided by private markets. However, markets cannot always be relied on to fulfil this task properly. One of the original objectives of the IMF was to provide short-term financing when reserves were inadequate to meet current account needs resulting from temporary trading shocks and disturbances, while the World Bank was to meet longer-term financing needs of reconstruction and development. For temporary payments disequilibrium, it was agreed that short-term financing was necessary in order to avoid sharp cuts in domestic absorption or disruptive exchange rate adjustments. Even when the effects of such shocks were deemed to be more lasting, IMF financing was believed to be necessary to allow orderly adjustment. Experience shows that financial markets often fail to meet such needs since they tend to be pro-cyclical, with the result that credit lines are cut off just when they are most needed. Given the increased instability of the external trading and financial environment of developing countries, a reform of the Bretton Woods institutions should seek to improve, rather than eliminate, counter-cyclical and emergency financing of the current account.

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F. Governance of international finance

There are certainly conceptual and technical difficulties in designing 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 a fail-safe system is unreachable. At the international level there is the additional problem that any system of control and intervention would need to be reconciled with national sovereignty and accommodate the diversity among nations. Political constraints and conflicts of interest, including among the G-7 members themselves, rather than conceptual and technical problems, appear to be the main reason why the international community has not been able to achieve significant progress in setting up effective global arrangements.

So far the major industrial countries have not addressed the establishment of a multilateral system for international finance based on a few core principles and rules preferring instead a strengthening of the financial systems of debtor countries in crisis prevention, and favouring a differentiated, case-by-case approach to crisis intervention. This approach not only has created asymmetry between debtors and creditors, but also has left far too much discretion with the major creditor countries, on account of their leverage in international financial institutions. It has kept out of the reform agenda many issues of immediate concern to developing countries, which are discussed in the following chapters. However, even a rules-based system raises concerns for developing countries: under the current distribution of power and governance of global institutions, such a system would be likely to reflect the interests of larger and richer countries rather than to redress the imbalances between international debtors and creditors. Such biases against developing countries already exist in the rules-based trading system, although relations here are more symmetrical than in the financial domain.

If reforms to the existing financial structures are to be credible, they must provide for greater collective influence from developing countries and embody a genuine spirit of cooperation among all countries, facing many different problems but sharing a common desire to see a more stable international financial and monetary system. No less than a fundamental reform of the governance of multilateral institutions is therefore necessary.[11] The areas in which reform is needed are explored in a study undertaken for the G-24, which argues that governance within the Bretton Woods institutions needs to be improved regarding such matters as representation and ownership, accountability and transparency, and adaptation and change:

> The allocation of quotas and the correlate membership rights in both institutions no longer reflect the application of a coherent, justifiable set of principles: quotas no longer reflect relative economic and political power, and the principle of equal representation, which was once implemented by the allocation of “basic votes”, has been significantly eroded. Furthermore, decision-making practices have not adapted to the changed mandates of both institutions, whose work now takes them further and further into influencing domestic policy choices in developing countries. (Woods, 1998: 95)

While, as recognized in that study, efforts have been made to respond to calls for more transparent, accountable and participatory governance, the basic modalities and procedures for taking decisions remain largely unchanged. Thus, whereas developed countries account for only 17 per cent of voting strength in the United Nations, 24 per cent in WTO, and 34 per cent in the International Fund for Agricultural Development (IFAD), they account for over 61 per cent in the Bretton Woods institutions. And a single country holds virtual veto power over important decisions such as capital increases or SDR allocations. It is now agreed in many quarters that the procedures for selection of the Managing Director of IMF and the President of the World Bank should give greater weight to the views of developing and transition economies, since the *raison d'être* of these institutions is now to be found mainly in their mandates and operations with respect to these economies. More fundamentally, crucial decisions on global issues are often taken outside the appropriate multilateral forums in various groupings of major industrial countries such as the G-7 or G-10, where there is no developing country representation or participation. Consequently, "nothing consequential happens in the formally constituted organizations that *do* have operational capabilities – the IMF, the World Bank, the Bank for International Settlements – without the prior consent, and usually the active endorsement, of the 'Gs' (here used as a short form for all the deliberative groups and committees dominated by the major industrial countries)" (Culpeper 2000: 5).

If reforms to the existing financial structures are to be credible, they must provide for greater collective influence from developing countries and embody a genuine spirit of cooperation.

The inclusion of developing countries in the discussions of financial architecture reform that take place outside the Bretton Woods institutions, notably in the newly created G-20, is thus generally welcomed as an important step in ensuring better participation and governance in international finance. However, even though its first chairman, the Canadian Finance Minister Paul Martin, declared that the G-20 "has a mandate to explore virtually every area of international finance and the potential to deal with some of the most visible and troubling aspects of today's integrated world economy",[12] so far the focus of its work has not substantially deviated from the G-7 reform agenda, including a stock-taking of progress made by all members in reducing vulnerabilities to crises, an evaluation of countries' compliance with international codes and standards, the completion of the so-called transparency reports, and an examination of different exchange rate regimes and their role in debtor countries in cushioning the impact of international financial crises (Culpeper, 2000: 19). Furthermore, despite the G-20's broader membership, there are still serious limitations on participation and accountability:

> The G-20 is severely flawed in that it contains no representation … from the poorest and smallest developing countries. … Presumably, this is because the poorest and smallest are unlikely ever to constitute any systemic threat. But there are major "architectural" issues surrounding the provision of adequate development finance to these countries and their peoples. … Nor does the G-20 possess any mechanisms either for reporting or for accountability to the broader international community, such as the constituency system provides within the IMF and World Bank, or any provisions for non-governmental inputs or transparency. (Helleiner, 2000: 13–14)

A number of proposals have been made on how to reform the multilateral process as well as to improve the membership, accountability and reform agenda of the G-20. Certainly, progress in these areas will depend on the willingness of the major industrial countries to extend the reform agenda and process so that they also address the concerns of developing countries. It will depend no less on positions taken by developing countries themselves. As noted above, there is no consensus among the developing countries on several issues of the reform agenda. Many of the differences pertain to the modalities of official intervention in the management and resolution of

financial crises. Most countries appear to give priority to access to large amounts of contingency financing as a defence against contagion and instability, despite their concerns as to the appropriateness of several of its features. At times of crisis many countries seem unwilling to impose temporary standstills, preferring official bailouts, even though they often complain that their terms and conditions deepen the crisis, put an unfair share of the burden of adjustment on the debtors, and allow the creditors to get away scot-free. This unwillingness may partly reflect an assessment that the risks of imposing a standstill are excessively high when such action is still considered an aberrant response to a crisis (so far resorted to by only a few countries).

> Progress will depend on the willingness of the major industrial countries to extend the reform agenda and process so that they also address the concerns of developing countries. It will depend no less on positions taken by developing countries themselves.

There appears to be greater convergence of views and interests regarding measures for crisis prevention and governance of international finance. Objectives commonly shared by developing countries include: more balanced and symmetrical treatment of debtors and creditors regarding codes, transparency and regulation; more stable exchange rates among the major reserve currencies; effective IMF surveillance of the policies of the major industrial countries, especially with respect to their effects on capital flows, exchange rates and trade flows of developing countries; a less intrusive conditionality; and, above all, more democratic and participatory multilateral institutions and processes. Effective reform of the international monetary and financial system will ultimately depend on the ability and willingness of developing countries to combine their efforts around these common objectives, and on acceptance by developed countries that accommodating these objectives is essential to building a more inclusive system of global economic governance. ■

Notes

1 For a survey of these proposals, see *TDR 1998*, Part One, chap. IV; Akyüz (2000a); and Rogoff (1999).

2 For a useful summary of the history, structure, functions and legal status of the BIS, see Edwards (1985: 52–63). Until recently the principal shareholders of the BIS were 28 predominantly West European central banks, with those of Belgium, France, Germany, Italy and United Kingdom holding over 50 per cent of the votes. The United States Federal Reserve participates in meetings and committees linked to the BIS without being a shareholder. More recently the BIS invited additional central banks from emerging markets to become shareholders.

3 Kaufman (1992: 57); and "Preventing the next global financial crisis", *Washington Post*, 28 January 2001, A.17. See also speaking notes by H. Kaufman for the Extraordinary Ministerial Meeting of the Group of 24, Caracas, February 1998.

4 See also UNCTAD secretariat (1987), which reviews the experience with floating in the 1980s. In respect

of both the institutional hiatus and exchange rate behaviour little has changed in the past 15 years.

5 This proposal was first made in Williamson (1983).

6 Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, 24 September 2000, Washington, DC: para. 11.

7 Horst Köhler, Address to the Board of Governors, Fifty-fifth Annual Meeting, Prague, 26 September 2000.

8 See, for example, Wolf (2000); Eichengreen and Portes (2000); Summers (2000a); and also L.H. Summers' Testimony before the Banking Committee of the House of Representatives, 23 March 2000; and Goldstein (2000). For similar proposals, see the references in Rogoff (1999).

9 The concept belongs to Gerald Corrigan, quoted in Rogoff (1999: 27).

10 L.H. Summers, Testimony Before the Banking Committee of the House of Representatives, 23 March 2000: 14.

11 For an illuminating discussion of global governance issues, see Helleiner (2000).

12 Paul Martin, Speech to the House of Commons Standing Committee on Foreign Affairs and International Trade, Ottawa, 18 May 2000.