# Reforming the International Financial Architecture

On May 28–29, the IMF's Research Department held a conference, "Key Issues in Reform of the International Monetary and Financial System," with a twofold purpose: to broaden the debate on international financial architecture to issues of international and financial reform more generally and to allow experts outside the usual policy forums, notably from academe, to contribute to that debate.

Alexander Swoboda

INTEREST in reform of the international monetary and financial system, like recent capital flows to emerging markets, comes in waves. It surges with crises and ebbs when calm, however temporary, returns. In that respect, the 1944 Bretton Woods conference, which laid the foundations of the postwar international monetary and financial system, was a rare exception to this pattern. That interest in reform should now surge again is not surprising in view of the succession of crises that started with the crisis in the European Exchange Rate Mechanism in 1992–93 and continued with the tequila crisis of 1995 and, within two years, the Asian, Russian, Long-Term Capital Management hedge fund, and Brazilian crises.

The issues that underlie the agenda for strengthening the architecture of the international financial system—the current buzzword for reform of the system—are not new. This is not surprising, given that the goals of the system remain the same: to foster efficiency in trade in goods and assets; to ensure the stability of the system; and to allow for an equitable, socially acceptable distribution of income and wealth. The questions that need to be answered in this context also remain the same: how to share the burden of adjustment; what is the desirable speed of adjustment, and hence the desirable scale of financing; and what anchor should be provided for the international monetary system, to mention just a few.

Participating in the conference...

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These perennial issues, however, arise in new guises with changing circumstances. The latter include, most notably, the revolution in the technology of telecommunications and information systems that has underpinned and stimulated financial market integration and capital mobility, as well as domestic and international financial liberalization. As a result, markets for goods, services, and assets are becoming ever more unified, and developing economies have increasingly been drawn into these globalized markets. And private capital flows have come to play a dominant role in the financing of current account imbalances in advanced countries and an ever-increasing one in financing, and sometimes causing, the current account imbalances of developing economies. At the same time, policy is still made predominantly at the national level, even though markets are global.

## Mitigating instability

The program of the conference was designed to examine the appropriate policy and institutional responses in today's world of increasing capital mobility, at both the national and the international levels. The first part of the conference, on May 28, was devoted to the theme of mitigating instability under conditions of high capital mobility, or, if you prefer, global finance.

Instability has manifested itself in a variety of ways in the 1990s. First, exchange rates between major currencies—notably, the dollar, the yen, the deutsche mark, and, more recently, the euro—have exhibited both short-run volatility and large medium-term movements. These features of exchange rate behavior have raised concerns as to their effect not only on advanced economies but also, and perhaps more important, on third countries, particularly emerging market countries—that is, the developing, transition, and newly industrializing countries. Second, capital flows, first and foremost to emerging market economies, have been particularly volatile, with the boom phase of a buildup of large capital inflows followed by abrupt and equally large reversals.

Volatile exchange rates and abrupt capital flow reversals are, of course, not new, and the crises of the 1990s bear many similarities to previous ones, in particular to the debt crisis of the 1980s. There are important differences, however. Among them, one may mention the increasing role of private capital flows and, within that category, the increasing diversity of both issuers and holders of claims on emerging market economies; more widespread contagion; weaknesses in financial systems that make them particularly vulnerable to liquidity crises; and massive official financing packages that have not avoided extraordinarily large current account adjustments and output losses.

## Key issues in reform

These instabilities raise a number of key issues for the design of the international monetary and financial system. Several of them may be singled out here.

First, there is the evolution of the exchange rate regime for both industrial and developing countries. It is quite likely that, for the next few years, the exchange rates of the principal international currencies—the dollar, the yen, and the euro—will continue to exhibit a fairly high degree of volatility and some large medium-run movements, barring a major policy initiative to stabilize them. Such an initiative is unlikely in the near future and may, for that matter, be undesirable, although some steps could be taken to limit the most extreme currency misalignments. Fluctuations in the exchange value of key international currencies, however, have a severe impact on third countries—emerging market countries, in particular—and complicate their choice of an appropriate exchange rate regime. The new conventional wisdom has it that, particularly in view of the high degree of capital mobility, countries will increasingly move toward the ends of the spectrum that ranges from pure floating to hard pegs, as exemplified by currency boards or even dollarization. Whether two sizes fit all is, however, worth questioning, especially in view of the importance of the exchange rate for mid-size and smaller open economies that, for various reasons, do not want to choose a hard peg regime but lack the institutions required for a smoothly functioning pure floating regime.

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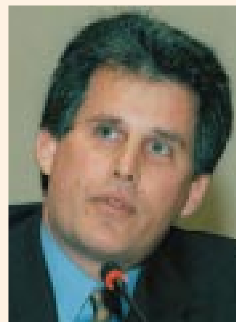

David Lipton
Carnegie Endowment
for International Peace

Takatoshi Ito
Hitotsubashi University

**Key Issues in Reform of the International Monetary and Financial System**

**May 28–29, 1999**

The following presentations were made at the conference:

*Keynote addresses*

Michel Camdessus, IMF Managing Director
Jacob A. Frenkel, Governor, Bank of Israel

*Papers*

Benoît Coeuré and Jean Pisani-Ferry, French Ministry of Economy, Finance, and Industry: "The Exchange Rate Regime Among Major Currencies."

Michael Mussa, Alexander Swoboda, Jeromin Zettelmeyer, and Olivier Jeanne, IMF: "Moderating Fluctuations in Capital Market Flows to Emerging Market Economies."

Guillermo Calvo and Carmen Reinhart, University of Maryland: "The Balance Between Adjustment and Financing."

Barry Eichengreen, University of California, Berkeley: "Involving the Private Sector in Crisis Prevention and Resolution."

David Lipton, Carnegie Endowment for International Peace: "The Financial Role of the IMF."

Takatoshi Ito, Hitotsubashi University, Japan: "The Role of IMF Advice."

*Closing remarks*

Stanley Fischer, IMF First Deputy Managing Director

Second, a better understanding of the reasons for the boom-bust character of capital flows to emerging market economies is essential for crisis prevention. Much emphasis has been put on policy failures and structural, especially financial, weaknesses in these economies, and these weaknesses have undoubtedly played an important role in recent crises. However, both the behavior of spreads on emerging market debt and the fact that the crises of the 1990s, unlike the debt crisis of the 1980s, were not preceded by major disruptions in the world economy that also substantially affected the industrial countries signal that dysfunction in the international financial system with respect to emerging markets may be among the root causes of recent turmoil. An assessment of these systemic aspects of the crisis, of the role of inappropriate incentives—be they moral hazard of one sort or another, inappropriate capital ratios, or perverse market dynamics—for both lenders and borrowers is essential when devising measures to strengthen the international monetary and financial system.

Third, there is the issue of what measures should be taken to deal with the instability of capital flows. Opinions here range from leaving it to unfettered markets to discipline both national policies and private agents, to tightly regulating capital account transactions. These extremes have the attraction of logical consistency but suffer from a decided lack of political realism. In practice, the debate concerns a number of specific measures. These include generally agreed improvements, such as improved transparency, standards, and codes of conduct incorporating best practices in such diverse fields as accounting and bank supervision. Although these measures are generally agreed to, their implementation involves some hard choices, and the devil is very much in the details. Other measures, such as capital controls, however market friendly, are more controversial. Finally, palliative measures, once crises do occur and default threatens, are particularly contentious, be they official emergency financing, stays of payments, or forced restructuring of debt.

Fourth, as already noted, current account adjustment in recent crises has been massive in spite of the availability of international financial assistance on an unprecedented scale. This raises both the issue of finding ways of achieving smoother adjustment—achieving a better balance between adjustment and financing—and the issue of sharing the burden of financing between the official and the private sectors, which is one aspect of the debate on involving the private sector in crisis prevention and resolution.

## The role of the IMF

These four interrelated issues were among those examined by the authors of the four papers presented during the first day of the conference and summarized in this issue of *Finance & Development*. The fifth issue, which was discussed in the two sessions that took place the following day, concerns the role of the IMF in the evolving international monetary and financial system—more specifically, the role of IMF financing and advice. The IMF's advice during the Asian crisis, discussed by Takatoshi Ito in his paper, has been the subject of much criticism and heated debate. Whatever one's views on this debate, it is important that what we have learned from it be applied in the future to IMF advice with respect to three of its fundamental areas of concern—macroeconomic policies (monetary and fiscal), the exchange rate regime, and the scope and timing of conditionality with respect to the structural aspects of the economy. Equally important are questions concerning the scope and modalities of IMF financing: for instance, should the IMF, as David Lipton suggested in his paper, reinstate strict access limits in its regular balance of payments lending but create a new trust fund that would act as a lender of last resort, but only in the event of a systemic crisis?

What is perhaps most important is that the current ebb in international financial turmoil should not lead to a slackening of the effort to find answers to these questions. It is essential that the system be strengthened now, for there are only two things of which we can be sure: crises will occur again and the next one will be different in some dimension from the last—and it will also be unexpected. F&D

*The full proceedings of the conference will be published by the IMF later in 1999.*