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Publication date
2003

Document Version
Final published version

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Vossiuspers UvA is an imprint of Amsterdam University Press.
This edition is established under the auspices of the Universiteit van Amsterdam.

Cover design: Colorscan, Voorhout
Lay-out: JAPES, Amsterdam
Cover illustration: Carmen Freudenthal, Amsterdam

ISBN 90 5629 266 8

The International Financial Architecture: What is New(s)?

Inaugural Lecture

delivered on the appointment to the chair
in International Finance Policy
at the Universiteit van Amsterdam
on October 22, 2002

by

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Vossiuspers UvA

Dedicated to Hans and Fritz, two very dedicated listeners

Mijnheer de Rector Magnificus, geachte collega's, familie, vrienden en aanwezigen,

Introduction

This inaugural speech is about what has been named the 'international financial architecture'. In short, the international financial architecture is about how the global financial system is organized and governed and how it as a result functions. In this speech, I will more precisely define the concept of the new international financial architecture, describe the changes to date and review the issues as well as the current official views. Most importantly, I will critically analyze progress and outstanding topics.

Given my background, my discussion will mix academic thinking with policy (that is, real-life) experiences. Hopefully, academics will provide the wisdom and policy the realism (although the costs of the realism are borne by my family due to many, often long, absences). Having been involved in some of the academic writing, policy-making as well as the design of reform programs for emerging markets facing financial crises, I may be able to better reflect upon some tradeoffs. Since I became acquainted with some of the actors in the international financial architecture debate over the past decade, I can also enlighten you with some personal anecdotes.

Let me say upfront that I do not claim to have all the answers as others have been accused of recently. Nevertheless, this is not the occasion to be modest and I will be, therefore, perhaps a bit more controversial than usual. In part, this is stimulated by a recent high-level panel discussion on 'Globalization: Blessing or Curse' where the political correctness was tiresome to listen to. As you may gather, Nobel Laureate Joseph Stiglitz was not invited. Thus, the main theme was twofold: 1) the new design of the international financial system is right; and, 2) it is only a matter implementing it. I beg to differ in two ways. Number one, the design is largely correct, however, wrong in some important dimensions. Number two, implementation faces some big obstacles. First, however, let me review why we are debating the international financial architecture in the first place.[1]

Why now the debate on the international financial architecture?

Why the debate and why now? The past decade has seen many crises, raising questions about the workings of financial markets. The East Asian crisis of 1997/98 was the main trigger for the international financial architecture debate. Then, not only a whole region but also the whole global financial system was affected by turbulence. Thus, events in emerging markets triggered the interest in improving the design of the international financial system. These past few months, financial markets have been volatile as well. This time, however, it is hard to argue that Argentina, Brazil or Turkey, or flaws in the design of the global financial system, cause this turbulence. The volatility now has been homemade and developed countries are reviewing their domestic financial architecture, including corporate governance, accounting and disclosure rules. Many of these issues have also been discussed in the international debate, however, events in emerging markets, not in developed countries, motivated the debate. This already relates to my main theme: developed countries have not been willing to admit that they may be a source of the problems themselves.

There have been many contributions to the debate, of varying quality, from the academically rigorous to the politically naïve. A Google Internet search on the term 'international financial architecture' yields more than 700,000 items; a library search gives 76 documents with those exact words in the title. To avoid any bias, I am only responsible for 385 of those items and none of the titles. To narrow the topic down, we need a definition of the term 'international financial architecture.' There is no unique one. I define it as the rules under which international capital flows take place, the way countries interact with the international financial system and the role of international financial institutions.

This definition may still seem very abstract and, additionally, since the reforms to the system have been prepared by a small group of policy makers, obscure to most other people and only with some outside or academic input (I can attest to this having now participated on both sides). One may thus wonder what the impact of any change can be on the everyday life of ordinary people. The international financial architecture is not an abstract notion and has many implications for all types of countries and their citizens. Global capital flows can lead to many benefits but can also have risks leading to currency crashes, rises in inflation, drops in output, increases in unemployment and so forth. Although affecting the lives of many, however, there is a big discrepancy between those insiders proposing and implementing reforms and those being affected. This anticipates my overarching theme: the balance of who is asked to reform is unfair. Too much is being asked from developing countries, too little is being done by developed countries and too little is being done to improve the system itself. We have to ask ourselves: are the reforms desirable because developed countries' financial markets are less likely affected adversely by the problems of one or a few emerging markets? Or will the reforms raise overall global welfare? The two are surely not inconsistent but who will make the reforms is often not fair. Let's next review what the issues are.

The issues in the international financial architecture debate

Let me start by defining the nature of the debate. The debate has invoked many analogues to the real architecture, for example, the designing and building of a house. Shall we ask for an interior decorator to make things look better although the house is falling apart? When can the plumbers and electricians come in to implement things now that we have redesigned the house? Shall we add to the house or improve what is already there? What is the new blue print: do we want an American-style or European-style house? As an academic and an economist, and thus based upon my comparative advantage, I will stick with the blueprint analogue and discuss the design of the new international financial architecture. I will leave the plumbing to the global bureaucrats and I think that the interior decorating is best left to the politicians. I will relate the areas of reform under discussion, starting with reducing the probability of a financial crisis and ending up with how to manage and resolve an actual crisis.

1. *Anticipating and reducing the risks of financial crises*. There have been many financial crises in the past decade. After the European Exchange Rate Mechanism (ERM) crisis of the fall of 1992, there was the Mexico crisis of 1994/95, the East Asian crisis of 1997 followed by the financial crises in Russia and Brazil in 1998. Further-

more, in the last twelve months alone there has been a very severe crisis in Argentina and financial turmoil in Brazil, to mention only the major countries. Thus, preventing currency and banking crises has been a frustrating exercise since the frequency and number of crises seem to been increasing. The problem is not that people are not trying to anticipate crises. Clearly, this would be very useful and profitable for investors. As such, a good topic for any master's thesis remains how to build a better model to predict financial crises. Success in precisely timing crises, however, has been very limited.[2] In part, the problem is data: we do not know all of the financial exposures and risks in a timely fashion. Mind you, insiders do seem to know, as often local investors are the first to take their capital out of the country or otherwise find some security before the crisis hits.

A deeper problem is that we do not have a good theoretical model. The literature started with the first generation balance-of-payments crisis model (Krugman, 1979 and Flood & Garber, 1984), followed by the multiple equilibrium models (Obstfeld, 1984 and 1986). Neither generation of models seems to be able to explain the more recent crises. Of course, academics are inventive and adjust their models, however, this is leading to models chasing the last crisis and missing the next one. We now have a proliferation of third generation models focusing on how interactions between real economy fundamentals, banking system structure, financial vulnerabilities in the corporate sector, market perceptions and even sunspots can lead to crises. In many ways, the recent models are derived from the first and second-generation crisis models combined with insights from banking-run models.

The one exception is the model of Dooley (2000). This argues that financial crises are ways for the well connected, domestic as well as foreign, to steal from the government and thereby from the public at large. Having been to many emerging markets during or following a financial crisis, I sympathize with this view. It would mean that the new international financial architecture needs to include some anti-theft devices to be installed in every country; or, in other words, locking up the pot of gold seems the best way to prevent risky behavior.[3] A nice analogue to real architecture is installing a burglar alarm. The question, however, is who will come to the rescue when the alarm goes: a security guard (the private sector) or the police (the IMF)? Depending upon the country and one's own view, the calling upon either one of the rescuers can make things worse! Let me now continue with the issue of anticipating crises.

It is my view that we will never be able to explain the timing of financial crises; rather, there will remain a gray area of vulnerabilities where a banking or currency crisis is always a possibility, especially for countries with weak institutions. The difficulty is that the nature of the vulnerabilities varies greatly between countries. In Thailand, the risks were in the finance companies and in Korea in the actions of 'too-large-to-fail' industrial conglomerates (called *chaebols)*. In Indonesia, the risks were in the political system with too much rent deriving from one family, creating the risk of a political meltdown. In Argentina, the risks lay in the relationships between the central and regional governments. Even if we know the sources of risks the dimensions of the vulnerabilities remain very unclear. This is mainly because we know so little about how financial market participants interact and perceive risks. The analogue would be that in designing bridges at times certain combinations of materials used and natural forces – water, wind, temperature – can lead to instability and collapses which surprise architects and engineers. Unfortunately, the architects of the international financial system not only have to deal with natural forces but also with the unanticipated herding and stampede of participants in international financial markets that can be very damaging to any structure!

This does not mean that there is no value to building models to predict the next crisis. It can force less risk-taking and better policy-making. More intriguing, however, is why vulnerabilities are allowed to arise in the first place. In other words, what are the incentives not to actively manage risk? In developed countries, this can be the overall phase in the economic cycle. Clearly, as we observe now, good times can weaken the incentives for proper risk management. In emerging markets, poor incentives often trace back to moral hazard; that is, risk-taking induced by too generous government support especially in the financial sector. Additionally, 'too-large-to-fail corporations', weak transparency, poor corporate governance rules and ill-designed financial liberalization can increase vulnerabilities. In Thailand and Korea, government guarantees in the financial sector, combined with ill-planned financial deregulation, allowed too much risk to accrue at the final expense of the government. In contrast, when Brazil faced a financial crisis in 1998, the government's fiscal position was too weak for the private sector to expect large-scale bailouts. Consequently, risk management among banks and corporations was more active and a major crisis did not materialize. I must admit, however, that my observations are made with the benefit of hindsight and many expected a major crisis in Brazil in 1998.

The interactions between the various risks are also difficult to analyze. Stress test models exist primarily for individual banks but not for how interactions between various individual banks play out, for example, through the interbank market. Furthermore, we have little insight into how risks are propagated through financial markets through relative asset price movements, as occurred in the fall of 1998, affecting the financial markets of the United States and other developed countries. Additionally, interactions between official institutions can be hard to predict. I recall being in Korea in January 1997 and asking members of the Ministry of Finance and Economy whether they would be interested in jointly developing with the World Bank a better sovereign asset-liability management model. They clearly stated that they had no interest as they considered matters under control. At the same time, the Bank of Korea was arguing that risks were high, however, it had no influence over the Ministry. The Ministry and the Bank ended up in such conflicts at the onset of the crisis that it led to a very large foreign exchange loss in the fall of 1997.

2. *Strengthening financial systems*. This aspect refers to building more sound financial systems through enhanced regulation and supervision, better corporate governance, more disclosure and so forth. It is difficult to object to this element of the new international financial architecture. Not only can a better financial system reduce the chances of a crisis but it can also foster higher economic growth and increase the access of the poorer segments of society to finance, thus providing more opportunities to escape from poverty. The approach to strengthening financial systems has been developing new standards countries can adopt with the so-called 25 Core Principles for Effective Banking Supervision being the most important standard. Since financial sector development has been an area of my academic and policy work over the past few years, I will expand upon it.

At the individual country level, the emphasis on strengthening financial sectors has meant a regular 'check-up' entitled the Financial Sector Assessment Program or FSAP for short. One can think of it as the fire department checking the house for fire hazards every few years. Having participated in some of these exercises, I can attest to the fact that they are exhausting in many aspects. Groups of up to twenty experts go to a country, leaving no stone unturned, and produce massive reports written in well-polished language. Yet, here I am reviewing the international financial architecture and not the work of plumbers or decorators. This means that the policy focus for developing sound financial systems has to be right and here I have quite a few questions.

Most importantly, many countries are simply too small to be able to sustain their own financial system. Out of 106 developing countries, 78 had total bank deposits less than $10 billion. Out of those 78 countries, 41 had deposits under $1 billion.[4] In terms of equity markets, only 60 of the 106 countries had stock exchanges and, of these, 40 had a market capitalization below $10 billion. Ten billion dollars is a very small bank in most developed countries. Another comparison could be the Credit Union of the staff of the World Bank International Monetary Fund: it has total assets of $1.3 billion, meaning that it is larger than the financial system of some 40 countries. When the size of a country's entire monetary system is less than a small bank, then, is it realistic to develop a full-fledged financial system with a central bank, financial regulation and supervision and a stock and bond market? How can one assure effective competition when there is only scope for one bank? When poor countries have so few human resources, should they devote them to developing the financial sector? An anecdote illustrates the severe human resource constraints many developing countries face: in a small country, to remain unnamed, the fifteen-people strong World Bank/IMF financial sector assessment mission was having meetings with, as counterpart, the only economist in the country's central bank it had been able to identify!

A more realistic approach for many small countries is to import financial services. Capital flows are one form of import of financial services although they do come with some risks which I do not review here. Another form is the rapidly increasing trend of foreign banks establishing themselves in emerging markets. This has led to many benefits in terms of enhanced access to financial services, increased financial sector stability and more competition. Provided the system remains contestable, that is, open to further entry and subject to exit, the benefits of foreign banks can affect whole economies and not be limited to cherry-picking exercises. Similarly, foreign entry into other financial services markets, such as securities markets, investment banking and insurance can be very beneficial in small markets.

In addition to the possibilities of importing, I want to stress the electronic delivery of financial services across borders. Advances in technology now allow financial services to be provided within countries and across borders at much lower costs. The internet is but one, although a very powerful dimension, of these advances. Technology can also be used to broaden the access to financial services to the poorer segment of the population which is key in order to escape poverty. The technology exists, for example, to make a cellular phone into a small payment device similar to a chip-card. Many people in developing countries already carry 'cash' on their cellular phone in the form of prepaid balances. It is easy to conceive of a situation where such phones are used to make small-value payments and transfers. In Africa, for example, money handlers typically make cash transfers for city workers to their families in the rural areas at a hefty fee, not to mention at a considerable risk. Instead, balances can be electronically transferred between two pre-paid cellular phones, one owned by the city worker and the other, for example, owned by the local village head. Talking to people in South Africa, Brazil or other emerging markets makes it clear that the technology exists although barriers still remain.[5] One key barrier is the need to change the paradigm as the phone company becomes a bank while the current paradigm calls for any payments to go through commercial banks, even if insolvent, and via a central bank, even if incompetent. Many other examples of innovative use of technology exist and are waiting to be promoted to allow more access by the poor to financial services (Claessens, Glaessner and Klingebiel, 2002).

A second major criticism to the approach for developing financial systems is the better balance between government and market forces. Much of the approach to date has been top-down and state-dominated. Experiences show, however, that one ought to be more modest with regard to what governments can and will do. This modesty is based upon lessons learned from developed countries when these countries were still at the level of developing countries today. They then had financial systems that were very different from those they have today.

Many countries, for example, did not have a central bank before 1900: there were only 18 central banks at the beginning of the nineteenth century. The United States did not have a central bank system until 1914. Even when a central bank existed, it often evolved from a private bank as did the Bank of England. Following the Great Depression and World War II, the emphasis in the approach to financial sector development shifted and the state has became much more important in part because of reconstruction efforts in Europe and the export of this model to many (former) colonies. By 1950, there were 59 central banks and by 1990, 161 central banks. This sharp increase in central banks has not been matched by a rise in the general level of development. Many central banks have been faltering in pursuing their basic function: keeping a stable price level. It might be considered heresy to say it but do countries really need a central bank? Many countries seem to do quite well without one. One of the more recent central banks is actually Luxembourg, which established a bank with less than 200 employees. Its only purpose was to get a seat on the ECB-board. Luxembourg, however, did fine before it had a central bank.

The central bank example is important as it illustrates the risks of pursuing a top-down model too early in a country's development with too little attention to local circumstances and initial conditions. Using the architect comparison: throwing the blueprint over the wall and letting the locals figure out how to build it does not work if the building materials are very different and come from a generation or two ago. Similar considerations also apply to the role of the state in financial sector development. One cannot put all ones faith in minimally paid supervisors in developing countries since they are unlikely to be able to resist the temptation of corruption. Giving them more powers without checks and balances may actually make it worse as research has showed (Barth, Caprio and Levine, 2001) and many countries have discovered.

Can the paradigm move back to more market-based approaches? Importantly, this would include a smaller, publicly provided safety net for the financial sector. Today, many governments intervene through explicit or implicit deposit insurance if a large bank fails. Before the Great Depression, however, there was not a single deposit insurance scheme in the world. Private clearinghouses then attempted to avoid the collapse of one bank affecting a whole financial system. The United States adopted deposit insurance in the 1930s, however, many countries resisted it. For example, Canada did not have a deposit insurance scheme until 1967. After the 1980s, however, deposit insurance schemes sharply rose – from sixteen countries in 1980 to 68 in 1999, with two-third of schemes adopted in the last fifteen years alone. It does not take much economics to observe that this increase cannot be matched by an equivalent increase in the countries' institutional capacity to supervise. It is well known that deposit insurance creates moral hazard risks; that is, financial institutions will take more risks at the final expense of the government. Most (poor) countries cannot control these risks since they lack the capacity to supervise and they also cannot afford expensive bailouts. Although we do not have the data, I venture to say that one important way in which income distributions have become more uneven in many developing countries is through the costs of banking crises being absorbed by government budgets. While the station of deposit insurance may have passed for many countries, measures to limit the scope of it should still be pursued as much as possible.

Another related area where a different model is necessary refers to competition. Competition is an important but often neglected part of the financial sector development paradigm. While most economists (probably architects as well) believe that, as a first approximation, free competition delivers many benefits in most sectors of the economy, we tend to think otherwise in finance. Here, prudential concerns suggest that too much competition will undermine the franchise value of banks and thus induce too much risk taking. Yet, concern about too much risk taking, and the consequent tradeoff between competition and prudential policies, arises only because banks are treated as 'special' and have access to the public safety net, thereby inducing moral hazard. The special nature of banks derives, in part, from the state-dominated model of financial sector development reviewed before (Underhill, 2002). Increasingly, however, changes in global financial services industries make banks less special and competition policy thus more feasible and more important. Recent reviews in countries as diverse as the UK and South Africa have identified lack of competition as the main reason for the high costs and poor access of small firms and consumers to financial services. The European Union is also starting to get more active in competition policy in finance. While a shift in paradigm will take much time in developed countries, I would advise many developing countries not to fall into the same trap of having a highly regulated, rent-seeking type of financial system.

3. *Global Standards*. An important part of the international financial architecture reform efforts has been the promulgation of new standards to which a country can adhere. The financial sector is one area where the proliferation of global standards has been the most pronounced and I have mentioned some standards already. There have been, however, many other areas where the global community, in its wisdom, has developed new standards, ranging from corporate governance, accounting, bankruptcy, social policies, fiscal management, financial transparency and so forth. By some count, there are now more than sixty global standards to which countries can adhere. This raises many questions including which area is not subject to global standardization and when the standards are no longer useful.

Let me be clear: increased internationalization, a fact, although not uncontroversial, means that countries are transacting more intensely. Using the same terminology and rules can then lower transaction costs. The widespread, voluntary use of ISO-standards among corporations suggests that there is value to standards; however, standards which apply at the country level raise issues such as who sets the standards, who enforces the standards, how does one square the standards with countries' sovereignty and how does one apply penalties for any non-compliance.

Thus far, the advanced industrial countries have largely set the standards and some would argue special interest groups in those countries have been the main promoters. This runs against making standards broadly acceptable. The standards-setting bodies thus need to be widened. Standards also need to be realistic. A financial sector assessment in Poland illustrated to me that the level of openness required from emerging markets is very high and not even met by many developed countries. Can any low-income countries in Africa be expected to meet these standards? Standards also need to be adaptable, that is, they cannot be set in stone and need to change as circumstances change. Without continued change, standards can become the albatross of the world. Can international bodies, however, move fast enough? Witness the speed at which the new international capital adequacy accord for commercial banks (Basle II) is being designed. The world will look quite different when it will be adopted, if ever, let alone be implemented. This ought to make one much more modest when considering what standards can achieve.

Countries cannot be forced to adhere to rules either, even when they have participated in their formulation. One needs to create incentives for countries to adopt standards. There are many ways; for example, 'name and shame' of violators, as is being doing by public assessments and peer pressures. One can also withhold certain benefits, such as access to IMF lending-facilities. Other sanctions could be some exclusion of memberships. Still, enforcement will clash with sovereignty. We have seen how difficult it is even within the European Union for countries to live up to their promises, even when ex-ante rational. Whenever large fiscal deficits become convenient, promises are easily forgotten and it is very hard to come up with a mechanism to discipline countries especially when they are large. This is, of course, even more so when rules are not rational as may have been the case for the Stability and Growth Pact. This shows that standards without credible enforcement are not that useful.

Furthermore, who is in charge of the assessments? Are the graders really well-rounded experts? Having seen some of the work that is being done, and realizing the inevitable personal judgements, I have some doubts. This weakens the value and comparability of assessments. An anecdote here is appropriate. The Polish and Hungarian banking supervisors quickly compared the assessment of the quality of their regulatory and supervisory systems. Noting some differences, they went back to the assessor and asked: why do we have a lower score than they do? This must sound very familiar to the people teaching who have students come to you to complain about their grades!

4. *Exchange rate management*. A mismanaged exchange rate is a euphemism for a currency collapse. As such, every currency crisis has a readily identifiable cause: the currency was mismanaged! This could be the verdict a macro-economist, which I hope are few in the audience. Having made fun of macro-economists, let me relate an anecdote on how a micro-economist approaches exchange rate management. A World Bank colleague and I were having dinner with Joseph Stiglitz in Bogota, Colombia in October 1997 in the middle of the East Asian financial crisis. We were discussing how to stabilize currencies as we were writing a note to the East Asian Ministers of Finance. Joseph Stiglitz suggested an optimal tax regime that would stabilize currencies perfectly. It would entail a progressive tax with the rate depending on how much the currency would move. It was very ingenious, however, completely unworkable as the tax would surely be avoided 100%!

As I think I have made clear, exchange rate management is not my area of specialization, however, the macro-economists do seem to vary in their views of what the right exchange rate model is for emerging markets. Fully floating is now the acceptable exchange rate regime. Only some two years ago, however, the other option, a fully fixed exchange rate, or a currency peg, was considered an attractive option as well. Suddenly, post-Argentina crash, the wisdom seems to have changed and is now leaning towards 'managed floating plus', as Goldstein (2002) has called it, as the only option. That is, you allow the currency to float, target a reasonable inflation rate to tie down price expectations and do some additional reforms, such as limiting foreign exchange exposures in the banking system. This sounds reasonable although the macro-economists may change their views again. Still, there are some puzzles for a finance person.

First, why do so many countries mislabel their exchange rate regimes? A recent study has found that the so-called currency peg, that is, fixing the exchange to another currency, is half of the time really a variant of a float. Also, when the official classification was listed as floating, it was often a form of a de-facto peg (Reinhart and Rogoff, 2002). Second, if floating is the best, why do some many countries accumulate so much foreign exchange reserves, for example, in the case of Korea more than $100 billion? If they are truly committed to float then they need not have any reserves. What is this 'fear for floating'? Some academics, like Calvo and Reinhart (2002), have argued that floating is no panacea for emerging markets, different than for developed countries, because of credibility and market access issues and poorly developed local financial markets, including limited markets to hedge. This seems, however, very debatable. Does having a managed regime that collapses once every ten years create more or less credibility than a daily-adjusting exchange rate?

I think we need more microeconomic-based models to determine which exchange rates system might be good for emerging markets. For one, too little attention is being given to what the costs of exchange rate variability might be for corporations and the resulting impact on trade. Are the costs really that much higher for emerging markets than for developed countries? Does the government managing the foreign exchange rate not lead to less development of hedging markets and, as such, do countries not get caught with occasional but very costly crises? More research on the micro-foundations of 'the fear of floating' is thus called for.

5. *The functioning of the IMF and World Bank.* The international financial architecture is greatly influenced by the two so-called Bretton Woods institutions: the International Monetary Fund and the World Bank.[6] They used to operate in mystery and probably still do to most people in the world. In practice, the World Bank is quite open which is well known – in my architecture parallel: 'it is leaking everywhere.' Much has changed at the IMF in the last decade and the institution is much more open today than it used to be. The IMF website, for example, has very useful information on current country programs. While more open in communications, less has happened in terms of the conditions at which the IMF and World Bank lend and how they are being influenced by their (major) shareholders. From perhaps too much activism under the previous US administration, the current administration is now noticeably (too) passive or perhaps too inconsistent.

Admittedly, the IMF was stretching its mandate and increasing the size of financial packages it was making available in the 1990s. Now, it is trying to limit the size of financial packages but in a haphazard way. The case of Argentina has been particularly distressing. Argentina has alternated between receiving and not receiving IMF support. In December 2000, a $40 billion package was agreed to be disbursed in the spring of 2001 but then it was (indefinitely) postponed. Later again, in the early fall of 2001, Argentina first needed to do a private debt reduction before receiving any new funds. Finally, Argentina was told that it would not be receiving assistance whatsoever until it had done 'everything'. Being in Argentina in September 2001 made it all the sadder for me to see how such a great country has suffered from these gyrations in policy. This is not to say that Argentina did not make many mistakes as well. However, it and other countries have become victims of international financial architecture experiments. There has to be a better way to balance the varying geopolitical interests with the individual country's and the global financial system's concerns.

The rules for the international financial institutions also involve the balance between the Bank and the IMF, an issue for some time. Although the two institutions have separate mandates there is considerable overlap and some competition which is not all that bad. There is also considerable cooperation at the working level that goes unseen by many (perhaps as there actually is a tunnel between the IMF and the World Bank which many, even some in the institutions themselves, do not know about.) Let me stress the differences between the two institutions: in its development agenda the World Bank is often compared to the Stanford University Marching Band: lots of creativity but not all brought in line to a single purpose so it sometimes (or often) sounds awful. The IMF, in its crisis management, is like the army sending in the troops to rescue a country: very effective, but not very pretty.

Another anecdote can illustrate the differences. I was in Bangkok in August 1997 when I noted the arrival at my hotel of the first IMF mission to design a program and to be followed by many other missions. I called the World Bank headquarters in Washington and suggested that I would join the mission as it was clear that Thailand was not just facing a balance-of-payments crisis but had some structural problems, which the World Bank had actually been working on for some time. Headquarters would have to call across the street to the IMF to coordinate my joining the IMF-mission. Sadly, however, the Bank had just reorganized and no one in charge could be identified to make the call across the street. From then on, the cooperation between the Bank and the IMF during the East Asia financial crisis never really got going.

Some observers have suggested merging the two institutions. I think this might well kill off the good parts of either and lose the competition that may be helpful. Cooperation in the end is very much an issue of personalities and, although the mix has not been very good in the last few years, the current chief economists of the

World Bank and IMF (Nick Stern and Ken Rogoff) have reportedly been getting along better, although probably more boringly. Still, however, one has to design the fence between two houses and the tunnel under the street, independently of whom the current occupants are and thus the issue remains.

6. *Restructuring and recovering from a crisis*. Having discussed how one can try to predict and prevent crises, it has to be clear that there will be many more crises. New types of problems not yet anticipated will arise and euphoria does tend to plant the seeds for busts. Crisis management has to be part of the international financial architecture, yet it has received less attention than prevention. (A parallel here to architecture might be that in designing a house it is hard to already have in mind how one can best reuse or recycle the building materials when it will be wrecked.) Clearly, it is the worse time to discuss changes to the system in the middle of a crisis and, since we have had quite a few crises, there may not have been a good time to discuss the modalities under which the restructuring ought to take place. Still, it will not be a better international financial system until the ex-post restructuring process is ex-ante clarified. The two are closely related through, among others, the moral hazard of bailouts.

Restructuring has many dimensions among which the restructuring of sovereign claims, that is, public debt is the most important to consider. It has had a long history which shows the complications of implementing any ideas. We first discussed this in the late-1980s at the World Bank (with people such as Richard Portes, Barry Eichengreen, Ken Rogoff and Jeffrey Sachs). Conceptual work on the restructuring of sovereign claims was continued (by Eichengreen and Portes and a related G-10 report of 1991), however, it was not followed up much either. The issue has become more important in the last decade as the diversity of claims and investors has greatly increased, making coordination in restructuring cases more difficult. In the 1980s, one could get a small number of commercial banks around the table to renegotiate sovereign debts whereas today one faces many bondholders and other creditors.

I am stressing coordination because theory indicates that this is the key feature of any bankruptcy and reorganization regime. Coordination has become more difficult in the last decade as the ability of bondholders and banks to take losses today is probably better than that in the 1980s, making them less eager to coordinate. Coordination also greatly matters in practice, as I saw up-close in the East Asia. Commercial banks lending to Korea were cutting their credit lines sharply in December

1997 and foreign exchange reserves were going down to zero. Finally, just before Christmas, the G-7 deputy ministers of finance swung into action and coerced their banks to roll over loans to Korea. It involved having to reach the chairmen of the largest German banks on Christmas evening, at which time some had already left for their vacation houses in the Alps![7] Many countries, including not only Argentina and Korea, but also Bulgaria and Ukraine, have had to suffer from the lack of a consistent approach for restructuring of claims and the dominance of pragmatic, yet ad-hoc, experimentation.

A more formal procedure for restructuring of sovereign debts is thus needed. The IMF is making some progress following proposals in November of last year under the name Sovereign Debt Restructuring Mechanism or SDRM. The debate in the past months, however, has not been helped by the fact that the US administration has sent confusing signals as to whether it really wants to make any changes. In part, this pose probably reflects the desire to protect investors in developed countries. Oddly, this actually runs counter to the administration's own proclaimed desire for less bailouts and more market-type based forms of sovereign debt resolution. Perhaps the confusing and inconsistent signals just show lack of good economic thinking. While it is amazing how poor financial markets can function at times, it is even more amazing how poor policy makers can function.

As a non-econometrician, I therefore propose an addition to the many regressions that are being run to explain whether a crisis in one country affects the chances of a crisis in another country. The additions are two 'Paul O'Neill' dummies: a dummy whenever the US Secretary of the Treasury gives a speech, as spillovers will then likely increase; and, another dummy when he goes to a country for the increased likelihood of an (even larger) bailout package forthcoming as the situation has gotten worse![8] By the way, you can replace the name with you own favorite issues and policy maker – for example, Duisenberg – in the case of monetary policy.

Luckily, last month the G-7 countries finally provided support for developing a sovereign bankruptcy regime. Now, the IMF has to develop a 'concrete proposal' that will allow indebted countries to declare bankruptcy. While the action represents a milestone in the effort to overhaul the architecture of global finance, the detailed development will still take some time. The analysis will have to tackle issues like the scope of the debt to be included, how to protect creditors during the negotiating process, how to structure the dispute resolution process and so forth

(Krueger, 2002). Many tradeoffs are known, however, from domestic bankruptcy procedures and carry-over to the international context. As such, the analysis could proceed quickly.

The complications arise because, compared to a firm in distress, there are fewer objective measures by which to establish the true financial situation of a country. How can one determine the true value of a country? Where does one draw the line between the interests of the creditors and the social and economic needs of the country? It is clear that Argentina cannot pay more since social disruptions undermine the stability of the government itself. If anything, too much has been asked already. For other countries, however, the line is less clear. Who will decide on what is socially acceptable or not? The IMF? It raises issues such as who will be judge in a sovereign bankruptcy and who will declare a standstill; that is, a halting of payments? Furthermore, a sovereign does not have to abide by any rules and using gunboats to retrieve claims is ruled out these days (it used to work during colonization). Rather, implicit sanctions are needed to get a country to repay. This makes the credibility of any sovereign debt restructuring depend upon international political economy factors.

A key way in which restructuring could easily be facilitated is for the IMF to lend more freely into arrears, that is, to lend although the country is not current on all payments to its private creditors. A greater willingness to lend into arrears means that the IMF no longer directly 'bails out' private investors, as it would without allowing for arrears.[9] The IMF would also 'legitimize' the running of arrears through signaling to domestic and foreign investors that it considers the program credible and thus help restore confidence. Lending into arrears can also have legal benefits as the ability of creditors to seize assets may be less when the IMF has sanctioned arrears. To date, the IMF has rarely lent into arrears. This illustrates my point that it is often more an issue of political will to foster a better international financial architecture than of technicalities.

How to go forward – broadening the debate and inputs

Let me be clear on my main two messages: the balance in terms of who is asked to reform is skewed, which, in turn, is undermining the chances for real, deep change.

Additionally, the reforms being proposed and implemented are flawed in some important respects.

In terms of the first, I would be the last to deny the many shortcomings developing countries have – in their financial system, public and corporate governance, judicial systems and in other many aspects. I have encountered them first hand too often and have seen their consequences – in terms of increased risk of financial crises, distorted resource allocation, high fiscal costs and so forth. There is, however, also a large degree of 'irrationality' in the global financial markets and the system for preventing and resolving financial distress is still very weak at the international level. To correct this balance will require many efforts. So far, unfairly, the burden of reforms has been mainly put upon emerging markets. Most urgently, a better regime for sovereign debt restructuring needs to be implemented and the IMF needs to revisit its policy of lending into arrears.

In terms of the second theme, the approaches for strengthening financial systems, key to preventing crises, are very much based on blueprints we know in the developed countries today. Blueprints today, however, ignore lessons from the past and do not capture the potential of the future. The lessons from the past suggest, most importantly, that one needs to be much less ambitious in terms of the role of the state, particularly in the financial sector. The potential of the future suggests that developing countries will have even greater possibilities to acquire services, institutions as well as institutional frameworks, from more advanced countries rather than to make them at home. Both the lessons and the potential strongly suggest that the nation-based model to financial sector development is not an efficient one to pursue in many developing countries.

These lessons have been mentioned before. However, the fact that they do not seem to be reflected in the debates is that they require changing the governance of global reform, which is no small feat. How can one change the global debate? Partly, it requires a more unified view from countries other than the major developed ones. Why is there a concept called 'Washington consensus' but not any counter view? On aid and development, for example, Europe is providing much of the aid but why not also more influence on how it ought to be spent? To date, the political views from Europe have often been scattered among its member states with narrow political interests regarding specific developing countries or issues hindering a single voice. Japan has had little or no independent, or, at best, a more mercantilistic view of development. Developing countries have been increasing their voice and today there is more recognition that they are key partners but they still lack advocates in financial matters. Views from Europe or Japan have also not been enough clearly focused. This concerns the international financial architecture but also the debates on globalization, aid-and-development and debt relief for the poor countries. It is evolving yet it needs much more support and work.

The changes must also come to academics. A better debate means opening up the academic groups and issues. Much of the discussions are on the same topic and between the same academic crowds but meeting on various continents. I will provide another anecdote. I have been somewhat eclectic in my research, sometimes returning to issues I have worked on years before. It is thus amazing to me how inward-looking research can be. On one such occasion, the most progress I could discover was that some of the independent variables were no longer considered 'exogenous'. The many conferences on various continents are also not very helpful. I must say, too much of the time the same people are talking to each other (I admit here to being part of the problem). It is a traveling circus yet not as exciting. Perhaps architects have found a better way to discuss blueprints amongst themselves by sending them over the internet rather than having to meet in person.

Ik heb gezegd.

Notes

1. For other reviews, see Kenen, 2001 and Fischer, 2002.
2. See Goldstein, Kaminsky and Reinhart, 2002 for a comprehensive review of Early Warning Systems and new modeling.
3. There is some supportive evidence: Acemoglu et al., 2002, for example, find that volatility is lower in countries with more restraints on the executive, i.e., with more democratic regimes. They explain that without restraints, the executive is more willing to create volatility to expropriate. Johnson et al. 2000 find similar effects.
4. Source: Bossone, Honohan, and Long, 2001. The data excludes 26 other developing countries, all of which had deposits under $10 billion, and none of which had stock markets. These countries were excluded either because their data appear to reflect a role as an offshore financial center, or because they experienced large movements in offshore deposits during the period.
5. These barriers include legal framework, privacy laws, and telecommunications infrastructure. Important will be education: how to teach an illiterate person not to throw away a card, but keep it safe somewhere, although 'biometrics' may even be able to overcome the need for some card.
6. For a recent review of the international financial architecture with a focus on the role of the IMF, see Fischer, 2002.
7. For more of these anecdotes, see Blustein, 2001.
8. Paul O'Neill has since resigned.
9. The degree to which the IMF bails out private creditors depends on the parameters of the program, and in the end the country is the one which pays for it, but the IMF facilities the final burden imposed on the country, and some leakage of payments by the IMF to the creditors is unavoidable.

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