TOWARDS A NEW INTERNATIONAL FINANCIAL ARCHITECTURE

Report of the Task Force of the Executive Committee

on Economic and Social Affairs of the United Nations

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EXPLANATORY NOTE

The establishment of the Executive Committees to coordinate the work of the United Nations entities working in related areas was an important component of the reform process launched by the Secretary-General in early 1997. The purpose behind this was to achieve greater effectiveness and consistency and thereby to enhance the usefulness of the Secretariat to the international community.

This report, “Towards a new international financial architecture”, is the product of a collaborative and coordinated effort by the Executive Committee on Economic and Social Affairs [1]/ and presents the unified position of the United Nations Secretariat in the economic, social and related fields on one of the most pressing issues of the day. The

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report was brought to fruition by means of a Task Force created by the Committee and

1. The international financial crisis and the need for reform

World events since mid-1997, and its precedents in the 1980s and 1990s, have made painfully clear that the current international financial system is unable to safeguard the world economy from financial crises of high intensity and frequency and devastating real effects. The rapid spread of the current international financial crisis, from East and South-East Asia to other developing and transition economies, and even to the industrialized world, has already led to statements and decisions by the authorities of developed countries, who recognize that it is indeed the most threatening event of its kind in more than half a century. The threat is reflected in the successive substantial downward revisions of forecasts of world economic growth in the last year and a half.

The crisis reflects, first of all, the tendency of financial markets to experience sharp boom-bust cycles. During financial booms, lenders and borrowers underestimate the risks involved in high levels of indebtedness, a fact that only becomes apparent, with particular severity, during the ensuing downswings and panics. This volatility is inherent in the functioning of financial markets. It reflects not only imperfections in the flow of information, but also radical changes in its interpretation and sharp revisions in expectations as new information arrives, shifts that can be severe because of the uncertainty intrinsic to the intertemporal decisions that underlie financial transactions. The liberalization of financial flows among industrialized and some developing countries, floating exchange rates, financial innovations and new communications techniques have increased not only financial transactions, but also volatility in recent decades.

The crisis has also demonstrated, with particular severity on this occasion, that financial crises are contagious; that under panic conditions markets do not adequately discriminate between countries with strong and weak economic fundamentals; and thus that crises tend to spread even to countries with sound economic structures and macroeconomic management. The concentration of participants in international financial markets that apply criteria indiscriminately to all countries is a major basis for contagion. In many cases, financial crises spread because highly leveraged investors, faced with losses in one market and ensuing margin calls, sell good assets in another country; investment banks and mutual funds may also engage in similar behavior in order to raise liquidity in expectation of withdrawals by clients.

Developing and transition economies have been highly vulnerable to financial volatility and contagion. They have been particularly prone to periods of rapid expansion and diversification of financial flows, often followed by abrupt reversals. This pattern has been aggravated by premature and hasty liberalization of the capital account, fragile domestic financial structures, and weak financial regulation and supervision. Extended financial booms build up strong pressures on aggregate domestic demand, which make macroeconomic balances unsustainable during the ensuing financial contraction. They also tend to weaken financial structures, as increasing risks are often underestimated. Under these conditions, the downswing may result in domestic financial crisis, which consumes large amounts of the scarce resources available to development, and severely affects economic activity and investment for several years. The impact of financial crises on the real economy is thus far larger than in developed market economies.

External debt and domestic financial crises generate, in turn, substantial social costs. As it happens, poor sectors of societ

With the full support of the international community, IMF should put together contingency funds to assist countries now experiencing crisis or contagion and others that could become the victims of world financial crisis in the future. These include countries that may be affected indirectly by the effects of such crises on trade and commodity prices, particularly low-income African and Asian countries. We therefore welcome the recent declaration and actions by the Group of Seven to guarantee adequate contingency financing, by completing the implementation of the IMF quota increase and the New aspects of international liquidity management, global consistency of macroeconomic policies and financial regulation, areas essential to the prevention and management of financial crises, as well as finance for development and the resolution of outstanding debt issues. This report addresses international monetary and financial issues in the first group, but some suggestions on broader and related issues are also provided.

With regard to the first group of issues, it must be emphasized that the present system is badly equipped to prevent financial crises and only partly equipped to manage them. Reforms in this area must be addressed with a sense of urgency in six key areas:

- Improved consistency of macroeconomic policies at the global level;
- Reform of IMF aimed at providing adequate international liquidity in times of crisis;
- The adoption of codes of conduct, improved information, and financial supervision and regulation at national and international levels;
- The preservation of the autonomy of developing and transition economies with regard to capital account issues;
- The incorporation of internationally sanctioned standstill provisions into international lending; and
- The design of a network of regional and subregional organizations to support the management of monetary and financial issues.

It is important to underscore the interrelated character of these reforms. Indeed, it is clear that reliance on any one or a few of these proposals would not generate a

preventive character, acting to warn of impending unemployment and growth retardation, as well as of inflationary pressures reflected in the evolution of domestic prices of goods, services and assets or in the deterioration of external balances.

The most appropriate institution or set of institutions to ensure such consistency should be subject to debate. Proposals include granting greater policy powers to the IMF similar grounds, with effective independent evaluations leading to accountable and pragmatic improvements in policy approaches.

5. The provision of adequate international liquidity in times of crisis

The management of international liquidity has a special role in preventing and avoiding contagion from financial crises and lessening their adverse economic effects. Whereas these objectives could eventually be best pursued through the creation of a true become the basis for a stable, low-conditionality facility for countries experiencing financial contagion. Countries that meet certain *ex ante* criteria would be eligible, and eligibility would be examined during Article IV consultations. Low-conditionality funds would then be made available, though at shorter terms and higher interest rates than traditional IMF resources. The corresponding criteria could include indicators such as those associated to current account deficits, the evolution of the exchange rate, the ratio of short-term debt to reserves, and the ratio of short-term and portfolio capital inflows to exports or GDP.

IMF resources should be enlarged in order to enable it to enhance the stability of the international financial system. Three channels can be considered. First, effective and swift mechanisms should be devised to increase its access to official funds in times of crisis. Second, it could be granted authorization to borrow directly from financial markets under those circumstances. Third, and perhaps most importantly, SDRs could be created when several members face financial difficulties. The SDRs thus created would be destroyed as borrowings were repaid. These mechanisms would facilitate the creation of additional liquidity at times of crises, without the painstaking negotiations of quota increases or arrangements to borrow. Moreover, current arrangements to borrow exhibit the shortcoming that they are activated only under systemic threat and after the approval of the suppliers of funds, with the corresponding delays in making new funds available to the Fund and the countries in distress. Indeed, the anticyclical use of SDRs to manage financial cycles should be part of a broader process aimed at enhancing their use as an appropriate international currency for a globalized world.

IMF conditionality is legitimate for drawings that are made when a country is

Moreover, conditionality should not be used to force the adoption of a specific exchange rate regime by any country. The experience of industrial, as well as of developing and transition economies in recent decades, indicates that a great variety of regimes can be successfully managed under the current world system. They range from currency boards to total exchange rate flexibility, including intermediate regimes such as crawling pegs, exchange rate bands and dirty floats. What should be made clear to national authorities is that the exchange rate regime they adopt should be consistent with fiscal and monetary policies, which vary according to the regime chosen, and that it may require complementary measures. Thus, fixed exchange rate regimes demand a larger amount of international reserves to be viable, and intermediate regimes generally require more active intervention in the management of the capital account. Therefore, it would appear that the best course of action in this regard is a pragmatic one.

Lastly, in order to avoid overkill, IMF should adopt general practices that allow for automatic reduction of the restrictiveness of an adjustment agreed upon with a borrowing country, if it becomes evident that the contraction of economic activity is greater than originally envisaged in the adjustment programs.

6. International codes of conduct, improved information, and enhanced financial supervision and regulation

A basic consensus in current discussions relates to the need for international codes of conduct in the fiscal, monetary and financial areas, for principles of sound corporate governance, for improved accounting standards, for greater availability and transparency

The design of minimum standards for financial regulation and supervision should go hand in hand with global regulation. An important proposal in this area is the recommendation to create a world financial authority –or a standing committee for global financial regulation-- in charge of setting the necessary international standards for financial regulation and supervision and of supervising their adoption at the national level. Such an institution could evolve from existing ones, such as BIS and IOSCO. This proposal would require significant expansion of the membership of these organizations. Alternative arrangements include strengthening existing institutions with broader membership, peer review and new regional and subregional organizations.

Minimum prudential standards must be designed not only to cover bank

In the case of industrial countries, we welcome the Group of Seven declaration of 30 October 1998 on the need to examine “the implications arising from the operations of leveraged international financial organizations including hedge funds and offshore

8. Incorporating internationally sanctioned standstill provisions into international lending and adequate sharing of adjustment

A standstill on debt servicing is an efficient alternative to disorderly capital flight, once a country faces severe international illiquidity. Capital flight is bad not only for debtor countries, but also for most creditors. Through chaotic exchange rate depreciation and interest rate increases, capital flight worsens the plight of domestic companies and banks, increasing the chance that what is actually a problem of illiquidity may turn into one of insolvency. Domestically, the economic and social costs of adjustment increase. Externally, the probability that creditors as a group may be repaid decreases. Moreover, bailout operations generate significant problems of moral hazard and an inequitable sharing of adjustment. Government guarantees, which are generally sought for the external liabilities of private debtors by international lenders in the renegotiations involved in these operations, increase moral hazard and equity problems. Indeed, they imply that poor sectors of society that did not share in the capital inflows will bear a significant share in adjustment costs, through cuts in social spending.

creditors are also likely to recover a larger proportion of the value of their assets through this approach. The costs of adjustment are also more equitably distributed. Article VIII of the Articles of Agreement of the Fund could provide a statutory basis for the application of debt standstills. To avoid moral hazard on

9. Design of a network of regional and subregional organizations to support the management of monetary and financial issues

Most proposals for the reform of the international financial architecture involve strengthening a few international institutions. It can be argued that stronger regional and subregional institutions can play a significant role, in terms of both the stability of the world financial system and the balance of power relations at the international level. The experience of Western Europe, from the Payments Union in the early post-war years to the European Union and the euro today, suggests that regional financial organizations and arrangements can play an essential stabilizing role. More limited experiences at a regional level, including regional and subregional development banks and a few reserve funds, indicate that they can also play an important role in a new international financial architecture, both in crisis management and in finance for development. Strong regional reserve funds would at least partially deter would-be speculators from attacking the currencies of individual countries and thus, among other dire effects, from threatening regional trade and financial relations. They could also supplement IMF funds in times of difficulty. Thus, on both the demand and the supply sides, they could reduce the need for IMF support.

Most regional financial institutions are small, where they do exist, and thus have limited effectiveness, but an investment in their development would certainly pay off in the long run. The design of the new architecture could thus introduce special incentives to develop such institutions. For instance, common reserve funds could be given special automatic access to IMF financing and/or a share in the allocation of SDRs, proportional to the paid-in resources. Indeed, in the long run, IMF could be visualized as part of a network of regional reserve funds, and its operation could then concentrate on relations with these reserve funds rather than on support to specific countries in difficulties.

Moreover, regional institutions and peer review could also play a central role in surveillance, both of macroeconomic policies and of domestic financial regulation and supervision. Indeed, such surveillance and peer review could be more acceptable to countries than that of a single, powerful international institution. It would contribute towards a more balanced globalization.

10. Complementary actions in the areas of finance for development and outstanding external debt issues

During the current crisis, the focus has been on countries with large financing needs that strain the resources of multilateral institutions. It is important that the attention given to these widely publicized cases and the large volume of IMF and bilateral funds that have been committed to them do not crowd out funding for, and international attention to, the problems of the poorest countries and hence to the financing of the Fund's Enhanced Structural Adjustment Facility (ESAF), the International Development Association (IDA) and the heavily indebted poor countries (HIPC) initiative. Nor should they be allowed to crowd out funding and attention to smaller countries that may be facing financial crises.

The inability of the Fund to mobilize all the resources needed for the rescue of countries in financial distress has required it to arrange financing from other sources, including the World Bank and the regional development banks. These institutions were not designed to provide liquidity to countries facing short-term external financing difficulties. A continuation of this practice would impair their capacity to fulfil their fundamental mission, which is to cater to the long-term development financing needs of countries with inadequate access to private markets.

Special attention should be given to safeguarding the access of the poorest countries to long-term resources, at the Fund, the World Bank and the regional development banks. Accelerated implementation of the HIPC initiative is also a world priority, but bolder debt relief initiatives should also be considered. The development banks could contribute to the alleviation of the worst effects of the crisis by providing financial assistance for the establishment or strengthening of gender-equitable social safety nets in both poor and middle-income countries. Strong protection for the poor during crises, through the design of effective safety nets, is still more a matter of rhetoric than of practice. Development banks also have a clear countercyclical role to play in world financial crises, a role that could be enhanced through innovations enabling them to work more actively to "crowd in" private-sector financing by rapidly disbursing co-financing funds or guaranteeing new debt issues of developing and transition economies. New, more effective rules on guarantees issued by these institutions must be designed to ensure this result.

11. The interdependence of the components of a new architecture

The goal of redesigning the international monetary and financial system is to harness the potential of private international financial flows to the service of stability and growth in the world economy. In order to pursue this objective effectively, it is important that the various components of the architecture be addressed at the same time. Indeed, these components are interrelated, and putting one or some of them in place in isolation will have limited impact in reducing the disruption caused.

Thus, improvements in supervision and regulation of financial firms are preventive measures that can reduce the incidence of crises and hence the need for IMF resources to cure them. However, since supervision and regulation are far from foolproof, financial crises and contagion will remain problems that need to be dealt with at the international level. Macroeconomic coordination and surveillance are essential to manage both inflationary and deflationary situations, which lie behind boom-bust financial cycles. Regional and subregional institutions could play an essential role as complements to IMF funding and surveillance activities, as well as in surveillance of domestic financial regulation and supervision.

Likewise, new financing facilities and standstill provisions are not substitutes for better regulation and supervision of financial institutions. Rather, all the above measures, along with domestic measures to deal with short-term capital movements, are mutually complementary. Rules regarding internationally sanctioned standstills are also no substitute for the establishment of an IMF facility to deal with contagion. Standstills have the unintended consequence of shutting off borrowers from access to capital markets for some time. Just as countries have legitim