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A Note on Issues in the Reform of the International Financial System

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The international community has so far been unable to achieve significant progress in establishing effective global arrangements to reduce the likelihood of financial crises and better manage them when they do occur. While certain initiatives have been taken in various institutions such as the IMF, the BIS and the Financial Stability Forum (FSF), the reform process, rather than focussing on international action to address systemic instability, has concentrated on setting guidelines and standards to discipline debtors, and providing incentives and sanctions for their implementation, on the presumption that the cause of crises rests primarily with policy and institutional weaknesses in the debtor countries. Little attention has been given to the role played by policies in creditor countries and the shortcomings in international institutions designed to safeguard financial stability.

This note focuses on global and systemic issues in discussing the reform of the international financial system. It is prepared for discussion on the International Financial System in the October meeting of Track 2, *Global Economic Agenda*, established in the context of the Helsinki Process. It is organized around a number of key, interrelated themes and questions with a view to helping determine the focus and priorities of the work of the Track in the period ahead. Most of these themes are elaborated in the book *Reforming the Global Financial Architecture: Issues and Proposals*, (Yilmaz Akyüz, Zed Books, 2002) made available to Track members, and their treatment here will be brief.

1. Regulation of international capital flows

Unlike international trade there is no global regime applying to international capital flows, including foreign direct investment (FDI). A number of proposals have been made in the aftermath of the East Asian crisis for the creation of international institutions and

mechanisms to regulate and stabilize international capital flows.

- Would it be technically and conceptually feasible to design fully-fledged global institutions for reducing the risk of financial instability and distress, such as 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 (Kaufman), or a *World Financial Authority* with responsibility and power for setting and enforcing regulatory standards for all financial enterprises, monitoring and mediating the imposition of capital controls by national governments and adjudicating disputes (Eatwell and Taylor)? Could they be expected to be more successful than the IMF in achieving international monetary and financial stability?
- How to reconcile such a system of global regulation and control with national sovereignty and avoid conflicts of interest? Could such a system be established on the basis of a distribution of power markedly different from that of existing multilateral financial institutions so as to address the main concerns of developing countries? Could we expect such an institution to be more even-handed than existing multilateral institutions in trade and finance?
- Would the creation of an *International Credit Insurance Corporation* to underwrite loans at a cost and to insure debt against default up to a threshold level (Soros) reduce the likelihood of excessive credit expansion and improve financial stability?
- Would it be possible to establish reasonably effective but less ambitious global mechanisms to reduce the risks of financial distress and contagion while leaving considerable autonomy to national governments in regulating and controlling external capital flows? More specifically, what is the scope for attaining greater financial stability by reforming the mandates, membership and/or governance of existing organisations such as the IMF, the BIS and the FSF that set codes and standards in the areas of financial regulation and supervision, macroeconomic policy and data transparency, and institutional and market infrastructure for implementation at the

national level? What are the limits of prudential standards and regulations in curbing financial instability?

- What kind of reforms would be needed to reduce asymmetries in the formulation and enforcement of codes and standards between debtors and creditors, to curb volatile capital flows at source and to increase the transparency of unregulated cross-border financial operations (including those of hedge funds)?
- What kind of incentives and sanctions would be needed for the implementation of such codes and standards? How could they be reconciled with national policy autonomy and legal and institutional diversity among countries?
- Should the Articles of the IMF be revised and strengthened in support of more vigorous regulation and control of capital flows in developing countries? Should a statutory protection be provided for controls over non-resident capital outflows at times of crisis, such as temporary debt standstills? (See section 5 below).
- Is there a need for a separate multilateral framework for FDI? Should such a framework address primarily restrictive business practices and abuse of market power by transnational corporations, regulate international mergers and acquisitions, and address the question of international competition policy, rather than the rights and obligations of host and home governments? How can such a framework reconcile the inherent asymmetry between developed and developing countries as investors and recipients? Where the negotiations and the power for enforcement should be placed?

2. The exchange rate system and policies

An important reason for international financial instability is the failure to establish a stable system of exchange rates among the major reserve currencies after the breakdown of the Bretton Woods arrangements. Indeed many observers (e.g. Volcker and Soros) have argued that the global economy will not achieve greater stability without some reform of the

G3 exchange rate regime, and that emerging markets remain vulnerable to currency crisis as long as major reserve currencies are highly unstable. However, the exchange rate system has hardly figured on the reform agenda. Clearly, developing countries cannot always be expected to solve their exchange rate problems unilaterally simply by adopting appropriate macroeconomic policies and exchange rate regimes, and the solution should also be sought at the global level.

- What is the best way to bring about macroeconomic policy coordination and coherence among the G3 in order to ensure stable and properly aligned exchange rates among the dollar, the euro and the yen? What role could IMF surveillance play in this respect? (See item 3 below).
- Is it sensible to introduce formal target zones among G3 currencies together with a commitment by the countries to defend such zones through coordinated intervention and macroeconomic policy action (Williamson)? Would such a system be viable in the absence of a certain degree of control over international capital flows? Would it not cause the kind of difficulties that had led to the breakdown of the Bretton Woods arrangements?
- To what extent can market volatility be overcome by measures such as the Tobin Tax? Would it address the problems associated with boom-bust cycles in capital flows and gyrations in exchange rates? Should the focus be, instead, on its role in generating revenues for financing development and global public goods?
- Is it sensible, in a closely integrated global financial system, to have so many independent currencies? (Hausmann). If neither flexible nor fixed rates work, should we not try to eliminate exchange rates by encouraging countries to adopt hard pegs, currency boards or reserve currencies as their national currency? Are such arrangements viable?
- Can viable solutions be found at the regional level? Does the post-Bretton Woods experience of Europe in establishing mechanisms for monetary cooperation and a

stable pattern of intraregional exchange rates and, eventually, a currency union hold useful lessons for developing regions? Should IFIs support regional currency arrangements and monetary cooperation among developing countries through special facilities?

- Has the threat of competitive devaluations increased as deflation has replaced inflation as a main policy challenge, and countries have come to rely increasingly on exports for growth? How to prevent countries from pursuing beggar-my-neighbour exchange rate policies, impeding orderly external adjustments and causing tensions in the trading system?

3. Multilateral surveillance over national macroeconomic and financial policies

Multilateral surveillance over national macroeconomic and financial policies is needed for two reasons. First, in view of the growing size and integration of financial markets, every major financial crisis now has global ramifications, and hence preventing a crisis is a concern not only for the country immediately affected but also for other countries. Second, national policies of major industrial countries exert a strong influence over global financial conditions and such influences can be destabilizing for other countries, particularly emerging-market economies.

The IMF surveillance over the policies in developing countries has not been successful in preventing financial crises despite its intensification and extension, inter alia, to financial sector issues. Policies recommended do not appear to be appropriate for dealing with the problems posed by large and volatile private capital flows:

- How to improve IMF policy advice to developing countries regarding external fragility, exchange rate policies and capital account regimes, particularly at times of massive capital inflows? Is there a need for an independent review of IMF's prescriptions? Should the United Nations constitute an external *IMF Review Commission* (Sachs)?

The failure of IMF surveillance to prevent financial crises in developing countries is also due to the unbalanced nature of surveillance procedures, which give too little recognition to the disproportionately large global impact of monetary policies in major industrial countries. Indeed most boom-bust cycles in private capital flows to developing countries and financial crises have been connected with major shifts in monetary conditions, interest rates and exchange rates in the major industrial countries. More generally, even though for most developing countries external financial shocks have become a much more serious source of disruption than trade shocks, there is no effective multilateral discipline over macroeconomic and financial policies of major industrial countries with a view to preventing their unilateral destabilizing impulses. In this respect governance in macroeconomic and financial policies lags behind that for international trade, where such mechanisms are part of the WTO regime, however imperfect they may be.

- Is it possible to set up a new multilateral framework based on a few general principles for disciplining macroeconomic and financial policies in the major industrial countries in order to reduce their adverse global repercussions, particularly for developing countries? Could mechanisms be introduced for redress and dispute settlement in these areas?
- Can the existing modalities of IMF surveillance be extended to deal effectively with destabilizing impulses resulting from shifts in the macroeconomic and financial policies of the United States, EU and Japan? Is it possible to introduce effective incentives and/or enforcement procedures linked to a process of peer review? How can one assure an even-handed approach between borrowing and non-borrowing members of the IMF in this respect? To what extent the proposal for the separation of surveillance from other functions of the IMF provide a viable solution (the UK Treasury)?
- Does the effectiveness of IMF surveillance depend on a fundamental reform of its governance structures? (See section 6).

4. Crisis intervention and management

Official intervention in emerging-market crises relies on a combination of lending with policy adjustment designed to restore confidence and stabilize the markets. However, there are problems regarding the modalities of provision of liquidity, and the policies promoted and the conditions attached to such lending. Assistance coordinated by the IMF usually comes after the collapse of the currency, in the form of bailouts designed to meet the demands of creditors, to maintain capital-account convertibility and to prevent default. Moreover, conditions attached to such financing go, at times, beyond macroeconomic adjustment, interfering unnecessarily with the proper jurisdiction of sovereign governments. Fiscal and monetary tightening and high interest rates advocated in response to crises generally fail to bring rapid stabilization, but instead deepen the impact of the crisis on the economy. Finally, provision of funds needed for bailouts often depends on ad hoc arrangements with large shareholders, opening the way to political influence. Accordingly, reforms in this area would need to focus on financing, policy response and conditionality:

- Is there a need for an international lender-of-last-resort facility? Should the IMF be translated into such as a lender (Fischer) in order to provide adequate and timely liquidity to countries facing financial panic and to support their currencies? Would it be possible to create such a lender without having the power to create its own liquidity? Would tight supervision over borrowers entailed by such an arrangement be compatible with national sovereignty?
- Does IMF lending create moral hazard for international lenders and investors, and encourage imprudent lending practices? What are the implications of crisis lending for the distribution of the burden of crises between debtors and creditors? Should there be a limit on IMF lending in order to prevent moral hazard and bail-in the private sector in crisis resolution? Should IMF lending above a certain threshold be made conditional on private sector involvement? Should IMF lending be separated from ad hoc bilateral arrangements to reduce the scope for undue influence over Fund policies?

- How to focus the Fund conditionality on the most essential areas directly related to the task of promoting macroeconomic and financial stability? Would it be feasible to provide a formal framework, delimiting areas of intervention and restricting Fund discretion in policy-making in developing countries?
- To what extent policies promoted in countries facing financial instability aggravate the consequences of the crisis for poverty and development? Are there adequate safety nets to protect the poor? How to improve policy response to crises? Is this issue related to the adequacy of Fund lending? Should maintaining an open capital account be an overwhelming objective in crisis intervention? (See section 5). How the issue of Fund accountability be approached? Should the Fund be financially liable for erroneous policy decisions?

5. Orderly debt workout mechanisms

Once a crisis occurs, it is difficult to avoid widespread messy defaults on external debt in the absence of bailouts but, as noted, bailouts are becoming increasingly problematic. Thus, 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.

- To what extent can national insolvency principles be applied to international debt, including temporary standstills, lending-into-arrears and debt restructuring and write-offs, as found, for instance, in the United States Bankruptcy Code? Is it necessary or feasible to establish an international bankruptcy court for sovereign debtors? What other arrangements would be possible? What role should the Fund play in such arrangements? How sovereign debt workout mechanisms be reconciled with national policy autonomy? Does the recently proposed Sovereign Debt Restructuring Mechanism go far enough in addressing the main issues?
- To what extent could international debt workouts rely on voluntary arrangements such

as collective action clauses in sovereign bonds, automatic rollover clauses in international debt contracts, call options in credit lines etc? Should one expect the markets to generate such mechanisms or is there a role for official intervention?

- Why are many developing countries resisting to voluntary as well as statutory arrangements for orderly debt workouts? Would they really impede their access to financial markets? Are such arrangements against their long-term interests?
- Should international debt payments by developing countries be subject to the constraints of attainment of internationally agreed goals such as the MDGs? Where the authority should be placed for the assessment of debt sustainability? Should official as well as commercial debt be included?

6. Governance of international finance

If reforms to the existing financial structures are to carry credibility and legitimacy, they must provide for greater collective influence from developing countries. This calls for fundamental changes in the governance structures of international finance, notably the Bretton Woods institutions which do not always meet the standards of good governance which they preach, including representation and ownership, and accountability and transparency:

- How to achieve adequate participation of all members in decision making in the IMF? How to reform the distribution of voting power in the IMF to reflect the economic size of its members? Is this the most important area of reform?
- Does the consensual process of decision-making on the Executive Board constitute a democratizing feature of Fund governance? Why do developing countries fail to exert a strong influence even though they collectively hold some 30 per cent of total voting rights? What reforms should be made to qualified/special majorities to reduce the veto power of major industrial countries and groupings?

- Should more advanced and larger developing countries be prepared to take greater responsibility in contributing resources for the operation of the Fund in order to have greater say in policy issues? How to ensure that they be given the opportunity to do so?
- To what extent the reforms needed would require an amendment of the Articles? How can the opposition of some major powers to such changes be overcome? Should not the Fund Board enjoy a certain degree of independence from governments in the way that the Central Banks do? Would that be feasible?
- How to improve the IMF governance to meet its own standards of transparency and accountability? What kind of organizational (as opposed to constitutional and policy) changes are needed to increase the voice of DCs in the IMF? How to lighten the burden of Executive Directors from developing countries and increase resources at their disposal, in their task of representing as much as 24 member countries, negotiating and monitoring their programs with the IMF?
- What kind of procedural changes can be introduced in the formulation and adoption of country programs so as to allow developing countries to have greater influence? How and to what extent can Fund programs be opened to the scrutiny of civil society in the member countries concerned?
- How to improve the procedures for the selection of the Managing Director and give greater weight to the views of developing countries? Should an independent body be established for evaluating the candidates nominated by member countries?
- How to ensure that there is no harmonization without representation? How to improve the representativeness of institutions and groupings such as BIS, FSF or G20? How can they be made accountable to broader international community?
- To what extent does the reform of the international financial system, including its governance structures, depend on developing countries forming a coherent and

consistent view on the issues described above? And what contribution can the Helsinki Process make in this respect?