

13. Constructing a New International Financial Architecture

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Hello, I'm George von Furstenberg, Robert Bendheim Chair in Economic and Financial Policy at the Lincoln Center Campus of Fordham University in New York.

I'm going to speak to you about constructing a new **international financial architecture**. This requires a little bit of explanation because the term "architecture" suggests a fixed, skeletal, rather static design, which is certainly not an appropriate analogy. It is more helpful to think of it as something like computer architecture, which has to do with sequential processing routines, or perhaps of building codes, or the engineering rules that underlie architecture. This leads us toward codes and standards as the most apt element of this analogy to architecture.

A. Setting Standards and Codes

Codes and standards set a basic grid on which the financial edifice is to be built. First of all, who creates those codes and standards for the international system? Who are the main actors? There are both national groups and international groups. The national groups are organizations such as, for instance, the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissioners (IOSCO). Groups of this sort are basically networks of the national regulators of the insurance field, the securities area and the banking area. The head supervisors of the banking area are part of the Basle Committee on Banking Supervision of the Bank for International Settlements (BIS). So they appear under an international hat, but it serves merely as organizer of the assembly of national banking supervisors, if you will. In addition there are certain important forums, such as the International Monetary and Financial Committee (IMFC), which is hosted by the **International**

Monetary Fund (IMF) in Washington, but really consists of the finance ministers of the countries most involved in international financial markets — in other words, the finance ministers of the leading industrial countries: the United States, Canada, the UK, Japan, Germany, France, and so on.

The IMFC, which is currently headed by Britain's Chancellor of the Exchequer, Gordon Brown, makes recommendations regarding changes in international financial regulations, as does another group that is called the **Financial Stability Forum** (FSF). The FSF is headed by Andrew Crockett and is lodged at the BIS in Switzerland. It co-ordinates initiatives regarding the **international monetary system**.

The content of codes and standards guides a very organized **financial sector assessment program** (FSAP) in which countries are encouraged to engage so as to take an inventory of the regulations and the de facto procedures, freedoms and processes of the various segments of the financial services sector in their country. This allows the sectors to be submitted collectively, with the aid of the **World Bank** and the IMF, to a financial stability assessment or the **financial system stability assessment** (FSSA), as it is officially called. In other words, they basically shine a light on all their institutional practices. They then examine what has been documented in terms of internal endogenous risks that arise in the operation of the system when it is stressed by various kinds of shocks that one can simulate. Then the international community helps to decide how these practices can be brought up to international standards for those elements of the constitution of these financial systems that are most prone to difficulties or crises. In the process, conforming to certain best practices, as evidenced by codes and standards, is the main

game. Bringing countries up to this conformance then creates system compatibility, reduces risk exposure to each other and therefore contributes to international stability, which helps all.

Transparency is one of those overused terms; however, it is important in this context. For instance, when the rules are changed for financial actors and there is excessive discretion in the formulation, or when the application of these rules is changed without prior announcement and essentially hits the actors by surprise, it is clearly disruptive for the system. It tends to undermine confidence in international systems because one does not know what is being played and does not know when or how the rules will be changed, with due notice, or does not know for what reasons the rules are being changed. Everyone can have different suspicions under such circumstances.

Investment in the improvement and the more generalized application of codes and standards that embody minimum requirements on the financial system are very important and very germane elements of the international financial architecture. For the first time, in fact, those elements of an international financial architecture are being consciously constructed, at least among the major players in international finance. This has both a **microeconomic** component and a **macroeconomic** one. The macroeconomic component is essentially handled by the IMF through its **special data dissemination standards** (SDDS). These relate to such things as the composition and extent of external debt — its composition by maturity, its composition by currency, as well as the reserve position. Timely reports on the state of international reserves (whether they have grown or declined) are required, as are reports on macroeconomic conditions generally. Timeliness as well as accuracy and verifiability of the data, and complete sourcing, are required to meet the SDDS. That is a macroeconomic component of transparency, done so that all can understand what

is going on in the particular country on a timely and comparable basis. I have already touched on the microeconomic standards relating to banking and insurance, and securities and market supervision. They would be involved here, too.

Let me go on with the software part of international architecture, which has not so much to do with fixed design, but more with software applications and the moving parts of the system. These, in many ways, are much more important. The moving parts of the system relate to doing what was touched on in Lecture 12, “Combating Financial Crisis,” namely preventing or alleviating banking crises, debt crises and currency crises. How is this done with some concreteness?

B. Constructing a Financial Architecture

To reduce the likelihood and severity of currency crises, there have to be rules for currency and maturity matching. For instance, one of the reasons the Southeast Asian crisis in 1997 proved to be so deep and intractable was that banks had unmatched liabilities. They were borrowing short-term foreign exchange and investing in domestic currency assets or at least in assets that were not credible foreign currency assets because the counter-parties did not have foreign currency receipts. As a result, the banks were extremely prone to crises due to exchange rate change. In addition, such factors as early intervention in problem banks (rather than continuing to bankroll them at public expense) and strict limits on explicit and implicit current government guarantees are very important to discourage banking crises and ensure that they are not excessively severe once they do occur.

Continuous monitoring and risk assessment are other important elements. There are now three pillars that have been promulgated by the FSF. First, they relate to capital adequacy standards — in other words, banks being properly reserved in relationship to the riskiness of the loans they make, or having risk-based capital standards. Second, they are also intended

to put in place risk assessment systems that are, at least in terms of their systemic or methodological portions, internationally agreed upon and approved. Those standards, however, are to be applied by the financial institutions themselves. Third, there is sufficient information to be given to the market so that the market itself can monitor the quality of banks, or determine the price of bank stocks, or determine the cost of inter-bank credit or whether they qualify for such credit at all, and so forth. These are steps that are viewed as helpful in keeping the banks on the right path or, should they stray, in making the costs somewhat less catastrophic than they have been in the past.

The next element has to do with preventing and alleviating debt crises. Again, transparency about the actual debt position of the country — no hidden debts — is important. Hidden debts have crawled out of the woodwork in a number of countries, so that the problem has been so much worse than it appeared initially and therefore became so difficult to resolve. You never seemed to get to the bottom of the problem until years had passed and everything was fully discovered. That should not happen in the future. There are many initiatives in this area for dealing expeditiously with sovereign defaults, such as **collective action clauses** (where qualified majorities or super majorities of creditors can decide for the minority creditor). Action can thus be taken without getting consensus, without getting unanimous agreement, or without encouraging strategic or tactical holdout behaviour on the part of a minority that basically prevents rescheduling or debt forgiveness, or some such remedial measures that appears necessary to all, from going forward in a timely manner.

International bankruptcy proceedings have not gone very far. And there are other suggestions for alleviating debt crises under international (meaning IMF) supervision. These include allowing for approved moratoria without the creditors being allowed to seize assets or disrupt the remaining financial dealings of

the country concerned. Many new initiatives under the umbrella of strengthening or improving the international financial architecture fall into this category.

Reducing exposure to currency crises is the last element. It involves such things as the early-warning systems already mentioned in Lecture 12 and, to some extent, improved surveillance and monitoring of these countries (in general by the IMF), in which the early warning systems would be only one of many and perhaps relatively minor informational inputs. Let me focus on just one particular activity, namely the so-called contingent credit lines. **Contingent credit lines** involve pre-positioning promises to come to the assistance of countries that, apparently through no fault of their own, are subject to speculative attack, perhaps on the grounds of **contagion**, because a country in the same vicinity, or with superficially similar characteristics, has come under attack, and this country fears it is likely to be next. In that case, if the country's past record has been such that it has been eligible to have a contingent credit lines with the IMF, it might be eligible for, in principle, unlimited borrowing; in this case, that borrowing would be designed to ward off the so-called undeserved speculative attacks on these countries. There are numerous problems with this option, and **moral hazard** is prominent among them. Once the country has been qualified by the IMF, it is extremely difficult for the IMF, regardless of how the country subsequently behaves, to withdraw the pre-qualification without precipitating a crisis. Therefore, there is a moral hazard element in such unconditional prior promises that is dangerous to handle.

C. Conclusion

There are other elements that need to be watched with great caution. But in conclusion, let us reflect briefly on what all this is ultimately about. Why do we wish to strengthen the international financial architecture? Surely, the ultimate goal is to contribute to greater

stability, as well as a more sustained economic growth, particularly in the developing world.

So this effort must somehow be combined with a poverty reduction strategy. Indeed, part of the change in the international financial system is to make the international credits, ostensibly for development purposes, more productive than they have been in the past by requiring a **poverty reduction strategy program** to be mutually arrived at between the parties and the potential lenders, including the international financial institutions. Once such a program has credibly been devised, it must be supported with the appropriate funds from the poverty reduction and growth facility, established essentially at the World Bank, with some potential backstopping by the IMF, and combined perhaps with debt relief for the **heavily indebted poorest countries** (HIPC's). Then you have a broad approach that does not deal with crises prevention with the upper-income and middle-income developing countries, where crises are most likely to occur, but also does something for those countries that are effectively still excluded from the international financial markets, which are the very poorest countries, particularly in Africa. Again, this is how the attempt to strengthen the international financial architecture branches off into the topic of generating global growth, which is the subject of the next lecture.

Further Reading

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- Germain, Randall (1999), *The Long Road to Reform: Current Political Obstacles to Reforming the International Financial Architecture*. Paper prepared for an International Forum on "The Challenges of Globalization," Bishop's University, June 6–8 <www.g7.utoronto.ca/g7/scholar/germain1999/index.html> (May 2002).
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- Huang, Haizhou and S. Kal Wajid (2002), "Financial Stability in the World of Global Finance," *Finance & Development* 39(1, March).
- International Monetary Fund (2002), *Global Financial Stability Report: Market Developments and Issues* (International Monetary Fund: Washington, DC).
- Kirton, John and George von Furstenberg, eds. (2001), *New Directions in Global Economic Governance: Managing Globalisation in the Twenty-First Century* (Ashgate: Aldershot).

Discussion Questions

1. Since the 1997–99 Asian-turned-global financial crisis, has enough been done to construct a new international financial architecture? If not, what are the priority next steps?
2. Is it the G7's uncertainty about how markets work in today's era of globalization or differing interests among the G7 countries that have most hindered the effort to construct a new international financial crisis?
3. What should the respective roles of the public sector and private sector be in the new international financial architecture?
4. Could a reformed international financial architecture have prevented the current Argentinian crisis?
5. Is there a need for an international bankruptcy court? If so, how should it be constructed and controlled?
6. Should the new international financial architecture be built by taking what has worked best within the United States, Britain and Canada and giving the world as a whole the benefit of such a system?

Quiz

1. IOSCO is the organization that regulates the industry of:
 - a. insurance
 - b. banking
 - c. securities
 - d. mutual funds
2. The Financial Stability Forum is headed by:
 - a. Davey Crockett
 - b. Andrew Crockett
 - c. Gordon Brown
 - d. John Manley
3. The Special Data Dissemination Standards are handled by:
 - a. IOSCO
 - b. the International Telecommunications Union
 - c. the Digital Opportunities Task Force
 - d. the International Monetary Fund
4. One of the major problems with contingent credit lines is:
 - a. lender of last resort
 - b. moral turpitude
 - c. moral hazard
 - d. surveillance
5. Collective action clauses work through:
 - a. supermajorities
 - b. a unit veto system
 - c. unanimity
 - d. weighted majority voting
6. HIPC countries are the world's
 - a. most mountainous countries
 - b. candidate members of the G7
 - c. the poorest and most indebted countries
 - d. countries that invest heavily overseas in ethical or "politically correct" ways