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Reforming the International Financial Architecture:  
What Globalization Critics Demand and What Policymakers  
Have (Not) Achieved \*

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## **1. INTRODUCTION**

The frequency and severity of financial and currency crises in emerging market economies since the mid-1990s have increasingly eroded confidence in the well-functioning of international capital markets. Cross-border currency transactions recorded a spectacular growth, reaching US\$ 1500 billion per day in the late 1990s or about two thirds of Germany's annual GDP. About 80 percent of these transactions involve round-trips of seven days or less. Globalization critics conclude that international financial transactions have little to do with real economic activity, such as foreign trade, and are predominantly speculative in nature.

In order to tame speculation and protect emerging market economies from the vagaries of global financial markets, globalization critics demand radical changes in the international financial order. Policymakers, notably those in major industrial countries, are criticized for remaining committed to liberalized financial markets. However, a fundamental reconstruction of the financial architecture does not only lack political support. As argued below, some radical reform proposals are also flawed from an economic point of view.

Yet policymakers are to be blamed for having delivered at best partly what they had promised after recent financial crises, namely to adjust the regulatory framework to increased global capital mobility. In important respects, the process of reforming the international financial architecture appears to be stalled, mainly because of conflicting interests of major political players.

## **2. SOME RADICAL PROPOSALS**

Three issues figure prominently on the wish-list of globalization critics: institutional innovations, a tax on cross-border financial transactions, and exchange-rate stabilization.

### ***New Institutions***

In arguing in favor of multilateral institutional innovations, one can refer to existing models on the national level (Eichengreen 1999: Appendix A). For instance, an international lender of last resort would resemble national central banks in fighting liquidity crises and financial panics by providing timely and sufficient emergency financing. Similar to national bankruptcy proceedings, an international bankruptcy court could halt the progression from

illiquidity to insolvency, by preventing foreign creditors from rushing for the exits and by arranging for a fair burden sharing between debtors and creditors.

Nevertheless, G7 governments agreed after the Asian crisis that sweeping institutional changes were not needed. Institutional innovations were restricted to the creation of the Financial Stability Forum and the G20 (which includes ten developing countries), both of which lack the authority to take binding decisions. Some of the arguments raised against new institutions are hardly convincing:

- The opposition to creating new international bureaucracies would be more compelling, if G7 governments were fighting against an overarching bureaucracy in their own jurisdictions.
- The reluctance to accept a loss in national sovereignty with regard to financial issues raises the question why multilateral rulings are generally accepted in international trade disputes.
- The argument that an orderly debt work-out is ensured by the existing Paris Club of official creditors ignores the problem of how to achieve a fair burden sharing with *private* creditors (see Section 3 below).

On the other hand, globalization critics underrate, or even ignore, the problems and trade-offs to which new institutions such as an international lender of last resort or an international bankruptcy court would give rise. As concerns the latter, it must be taken into account that insolvency is extremely difficult to define in the case of sovereign borrowers. Effective sanctions are lacking or difficult to enforce when sovereign borrowers are involved: a company's managers can be dismissed in national bankruptcy proceedings, whereas a country's government cannot be replaced by an international bankruptcy court. As a result, willful defaults and moral hazard behavior by sovereign borrowers are more likely. A similar dilemma exists with regard to an international lender of last resort. Containing liquidity crises effectively would require essentially unlimited emergency financing, but generous financial assistance may fuel moral hazard and give rise to further crises. Hence, national institutional arrangements cannot simply be copied on the multilateral level.

### ***Tobin Tax***

The idea to tax cross-border financial transactions was presented by the late James Tobin, a nobel-prize winner in economics, in the 1970s already (Tobin 1974). The Tobin tax may serve two purposes, namely to discourage short-term financial transactions and to generate tax revenues that may be used for financing global public goods (Raffer 1998). However, the more the tax succeeds in reducing short-term capital flows, the less revenues would be raised. The fund-raising function of the Tobin tax would also suffer if donor countries regarded tax revenues as a substitute for traditional sources of development aid.

The allocative function of the Tobin tax may be compromised by administrative problems and tax evasion. However, these arguments do not provide sufficient reason to dismiss the idea. No tax whatsoever could be levied if all loopholes had to be known and closed in advance. Moreover, tax evasion remains unlikely unless the tax burden exceeds the costs of evasion. A more important counterargument is that the suggested Tobin tax rates of up to one percent of financial transactions would not have prevented any of the major financial crises in recent years. For instance, the currency attacks on Asian currencies in the late 1990s offered short-term capital gains of around 50 percent so that the Tobin tax would not have made much of a difference. The Tobin tax may even increase the probability of crises if policymakers stick to inconsistent economic policies in the erroneous belief to be effectively protected against speculation and currency attacks.

### ***Exchange-rate Stabilization***

Similar to financial market volatility, erratically fluctuating exchange rates are counterproductive; they may seriously shorten the planning horizon of investors and trading partners. This concern is underlying the request for exchange-rate stabilization. However, there is no quick fix to this problem, even though globalization critics may claim otherwise. Proposals to embark on a "third way" between fixed parities and completely flexible exchange rates have been around for quite some time. In the late 1990s, the finance ministers of France and Germany suggested target zones for key currencies and advised smaller countries to peg their currencies to one of the key currencies (Flassbeck 2000).

This concept met with stiff opposition. The United States is not willing to subordinate monetary and fiscal policies to a mutually agreed exchange-rate target. Likewise, the European Central Bank would not like to see its monetary autonomy undermined. In other

words, the target-zone concept rests on unreasonable assumptions, notably that macroeconomic policy would be coordinated effectively among all major players. Without effective coordination, however, a narrowly defined system of target zones is prone to speculative attacks. It invites one-sided bets by speculators as soon as a currency approaches the (upper or lower) limit of the target zone and financial markets question the central bank's determination to keep the currency within the target zone.

Furthermore, the exchange-rate pegs proposed for smaller currencies seem to ignore the lessons from the Asian crisis and run counter to the predominant view on appropriate exchange-rate policies for emerging market economies (Fischer 2001). Erratic exchange-rate changes are most likely when the governments' commitment to pegged exchange rates is no longer credible. This is why an increasing number of emerging market economies have moved towards the corner solutions of the policy spectrum between dollarization and floating exchange rates. According to the evidence presented by Fischer (2001), the proportion of countries with intermediate exchange rate regimes fell considerably in the 1990s.

This is not to ignore that the debate on appropriate exchange rate regimes continues. Bergsten (2003) reckons the two-corner solution to be inoperable because few countries qualify for dollarization (or unalterably fixed exchange rates) and fewer still will accept free floats. Proponents of the bipolar view such as Fischer maintain, however, that soft pegs are not sustainable in countries which are open to international capital flows. Even though most countries' policies will still take some account of exchange rate movements, governments may choose among a wide variety of fairly flexible exchange rate arrangements.

### **3. REGULATORY REFORMS**

While various radical reform proposals are infeasible politically and flawed economically, it is beyond question that regulatory reforms are needed to keep up with increased global capital mobility. Relevant issues include financial safety standards, the regulation of internationally operating financial intermediaries, the contribution of private creditors to the resolution of financial crises, and the future role of the IMF.

Mutually agreed codes and standards cover a broad spectrum, ranging from data dissemination to fighting money laundering. At least from a developing country perspective, the acceptance and enforcement of existing core standards seems to be a more pressing problem than the design of ever more sophisticated codes and standards. The minimum

capital-asset ratio of 8 percent required by the Basle Accord provides a case in point. Reportedly, various developing countries failed to enforce this norm until recently, although it can be argued that an even higher ratio would be appropriate in the highly risky environment prevailing in many of these countries (Williamson and Mahar 1998). To close this gap, stricter surveillance by the IMF must be combined with effective technical assistance offered to developing countries.

### ***Supervising Banks and HLIs***

The original Basle Accord of 1988 has been under review since the late 1990s, in order to overcome regulatory distortions embedded in the traditional system of bank supervision. The new rules, known as Basle II, are scheduled to take effect in 2007. They offer two options of risk assessment: the so-called standard approach, which relies on external ratings provided by agencies such as Moody's, and the internal ratings-based approach to be developed by banks and audited by supervisory authorities. Both approaches aim at relating capital requirements more closely to the actual risk of bank assets.

However, Basle II may come at the cost of seriously impairing the access of developing countries to international capital markets. The new rules tend to widen the gap between borrowers enjoying investment grade and non-investment grade borrowers (Reisen 2001). According to critical assessments of recent drafts of Basle II, the internal ratings-based approach would sharply increase the capital requirements for lending to lower rated borrowers. As a result, developing countries would suffer from higher costs and/or a lower quantity of bank lending to them. Griffith-Jones et al. (2003) reject the view that all this merely reflects the more accurate measurement of risk. Rather, recent drafts of Basle II are said to overestimate the risk of bank lending to developing countries by failing to take into account the risk-reducing properties of an internationally diversified bank portfolio.<sup>1</sup>

Furthermore, capital requirements under Basle II may increasingly become pro-cyclical due to the reliance on the ratings by some agencies and the use of market-sensitive measures of

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<sup>1</sup> The benefits of international diversification through lending to developing countries result from the relatively low correlation of real and financial risk factors in developing countries with the corresponding risk factors in industrial countries.

risk.<sup>2</sup> Calculations by the Association of German Banks, quoted in *The Economist* (2003a), suggest that the new rules will result in strongly cyclical capital requirements for a portfolio of loans to about 4000 European companies and will discourage lending when companies need it most. In a similar vein, Reisen (2001) expects that Basle II will raise, rather than reduce, the volatility of private capital flows to developing countries and add to their vulnerability to currency crises.

Apart from revising bank supervision, attempts have been made to overcome the regulatory void with regard to the so-called highly leveraged institutions (HLIs), which include hedge funds. Significant credit links of HLIs with the banking sector pose a potential problem, as the financial system's stability may be at stake when major HLIs go bust. The Financial Stability Forum suggested in 2000 to test the effectiveness of an indirect regulation of HLIs (which focuses on the financial relations of banks with HLIs) before stipulating direct regulatory measures. Direct regulation of HLIs may comprise licensing requirements and minimum capital standards imposed on HLIs.

The argument most frequently raised against direct regulation is that HLIs may circumvent regulations, because HLIs either are located in, or could move to regulation-free financial offshore centers. This argument becomes less relevant, however, to the extent that offshore centers are brought to comply with multilaterally agreed financial safety standards. There is mounting pressure on offshore centers to do so. Disciplinary measures range from "black lists" (issued in 2000 by the Financial Stability Forum and the Financial Action Task Force) and stricter IMF surveillance to legal provisions that would prohibit financial transactions with non-cooperative offshore centers (as suggested by the German Ministry of Finance in 2001). As argued by Griffith-Jones (2000: 124), "if global supervision and regulation is genuinely accepted as essential in today's world of globalised financial markets, there can be no justification for 'no-go' areas, where such regulations could be evaded or undermined."

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<sup>2</sup> The problem with external ratings is twofold: First, the rating agencies were frequently late in warning of sovereign and corporate debt problems. Second, if external ratings become more widely used in bank regulation, they will increasingly affect the market; i.e., a rating downgrade may even trigger a crisis.

### ***Private Sector Involvement***

Similar to financial regulation, there is no shortage of proposals of how to make foreign creditors and investors share the costs of financial crises and, thereby, discourage reckless lending and contain moral hazard on the part of the private sector. For example, researchers have proposed to grant debtors the option of a unilateral debt rollover with a penalty (UDROP), to include collective action clauses in bond contracts, and to authorize the IMF to approve a temporary payments standstill when a crisis hits.<sup>3</sup>

Until recently, however, little progress was made in achieving a fair burden sharing. Major players disagreed on the basic approach to private sector involvement. European governments favored an obligatory and rules-based approach (Bundesministerium der Finanzen 2001). In particular the German Bundesbank took sides with the Meltzer Commission in that the overriding concern was to prevent moral hazard of private creditors resulting from IMF-financed bail-outs.<sup>4</sup> Hence, it was suggested to impose quantitative limits on IMF lending. Lacking an effective private sector involvement, however, this would have meant putting the cart before the horse. The demand that "even in the case of financial crises the IMF should provide only limited liquidity assistance" (Deutsche Bundesbank 2000: 15) conflicted with the systemic stabilization role of the IMF. This proposal also undermined the IMF's credibility; financial markets would have anticipated political pressure to violate ex-ante agreed lending limits as soon as a financial crisis was looming in an economically or politically important IMF member country.

For years it appeared that the proponents of a rules-based approach to private sector involvement were fighting a losing battle. This was mainly because the US administration supported the position of international banks, according to which burden sharing had to be voluntary and case-by-case. At the same time, emerging market economies were reluctant to support the European position, because of concerns that an effective private sector involvement would raise the costs of borrowing.

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<sup>3</sup> These proposals are discussed in more detail in Eichengreen (1999) and Griffith-Jones (2000).

<sup>4</sup> The Meltzer Report (2000) argued that the importance of moral hazard cannot be overstated, even though empirical evidence supporting this claim is weak at best (Nunnenkamp 1999).

The deep-rooted conflicts on how to involve private creditors led pessimistic observers, including the present author, to conclude that the reform debate was spinning in circles. However, the prospects for an obligatory private sector involvement improved when Anne Krueger, the IMF's First Deputy Managing Director, indicated in a speech in November 2001 that "a number of our members have expressed a desire" to adopt a new approach to sovereign debt restructuring (Krueger 2001). The core of Krueger's proposal consisted of a formal mechanism allowing a debtor country to declare a temporary payments standstill, during which the country would negotiate a rescheduling or restructuring of debt with its creditors.

Krueger's original proposal was revised in several respects, while the basic idea to mimic essential features of national insolvency procedures remained in place. Most importantly, subsequent versions took into account the objections, raised by politicians and academics, against the IMF playing a leading role in the process of sovereign debt restructuring. These modifications did not prevent the ultimate failure of the initiative by the IMF management. Emerging market economies such as Mexico remained strictly opposed to international insolvency rules (The Economist 2002). The United States sent conflicting signals for quite some time (Nunnenkamp 2002a), but, finally, took sides with internationally active banks which lobbied against any infringement of creditor rights. In spring 2003, IMF members decided no longer to pursue the idea of international insolvency rules.

It can be suspected that dilatory tactics by the United States were largely for gaining support among developing countries and their private creditors for a more modest approach to solving sovereign-debt problems. According to the market-based solution preferred by the United States, collective action clauses were to be included in debt contracts in order to prevent a small group of creditors from blocking debt restructurings favored by the large majority of creditors. US tactics were successful in that the previous reluctance of both borrowers and creditors to make use of collective action clauses was overcome. In the first half of 2003, several international sovereign bond issues containing such clauses "have been a resounding success, putting an end to emerging market countries' fears that such clauses would raise borrowing costs" (Finance & Development 2003: 4).

Yet, collective action clauses are second best to international insolvency rules. The latter would have applied to all outstanding debt, whereas the former principally apply only to new issues of individual bonds. The question remains how to achieve collective action among private creditors when various debt instruments are involved and inherited debt is significant. For collective action clauses to reduce the persistent uncertainty as to how future debt crises

will be resolved, several conditions have to be met: (i) collective action clauses have to become the norm in new bond issues; (ii) additional provisions are needed to combine the votes of holders of different debt instruments when it comes to a comprehensive restructuring; and (iii) existing debt instruments without clauses have to be swapped for new instruments with clauses. While the final verdict is open on all these counts, the recent exchange by Uruguay of almost all its privately held external debt into bonds with collective action clauses may sound an optimistic note (The Economist 2003b; Finance & Development 2003).

#### **4. REFORMING THE IMF**

Progress with regard to private sector involvement may also help redefine the role of the IMF.<sup>5</sup> However, the views on what the IMF should (not) do in the future differ considerably, not only between IMF members but also within major countries.

##### ***Conflicting Views***

IMF activities typically meet with stiff opposition in US Congress, while the US administration frequently resorts to the IMF in order to bail out strategically important debtors and their private creditors. In Germany, the Bundesbank supports the suggestion of the Meltzer Report (2000) to downsize the IMF, whereas the Ministry for Economic Cooperation and Development is strictly opposed to this idea. More generally, large parts of the international financial community want the IMF to refocus on its core competence in short-term macroeconomic adjustment and financial management, while many developmentally oriented IMF critics want to strengthen the social responsibility of the IMF.

Nevertheless, some common ground exists. It is widely agreed that the IMF should prioritize crisis prevention, improve financial sector surveillance, provide better and timely data, and make its own operations transparent. By contrast, a consensus appears to be out of reach in various other respects. Contentious issues include: the division of labor between international financial institutions, IMF lending operations, the type and scope of conditionality, as well as voting rights and decision processes in the IMF.

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<sup>5</sup> For a detailed assessment of the IMF, see Nunnenkamp (2002b).

### ***Lending and Conditionality***

The division of labor with the World Bank has become blurred, as the IMF increasingly engaged in longer-term lending and expanded the number of policy conditions attached to its loans. In several expert reports on the IMF's role, the case was made for the IMF to stop the so-called mission creep and to leave long-term lending, related to structural adjustment and poverty reduction programs, to the World Bank.<sup>6</sup> Put differently, IMF lending should be limited to short-term emergency financing and policy conditions should be restricted to macroeconomic and financial aspects.

Nevertheless, the future role of the IMF has been kept in limbo. While some major shareholders aimed at restricting IMF lending (see Section 3), the potential of IMF lending was actually expanded by the New Arrangements to Borrow (in 1997) and the creation of new credit lines (Supplemental Reserve Facility, Contingent Credit Line). Signals were also contradictory with regard to the terms of IMF lending: Access to the – so far unused – Contingent Credit Line was alleviated, whereas interest charges and maturities of other credit lines were tightened in order to discourage excessive drawings. The Poverty Reduction and Growth Facility is still placed in the IMF, even though an economically efficient division of labor would require the transfer of this facility to the World Bank (Williamson 2000).

It remains illusive to focus IMF conditionality on macroeconomic and financial policy aspects unless the IMF's role in longer-term financing is clarified. It is, thus, not surprising that mission creep continues. For example, Kenya had to agree to an unprecedented number of 60 policy conditions in summer 2001. Furthermore, policymakers hardly reacted to the more fundamental critique that (ex-post) conditionality did not work well in the past<sup>7</sup> and should, therefore, be replaced by pre-qualification criteria. Accordingly, countries would be able to borrow more easily and cheaply from the IMF if they had pre-satisfied certain conditions, including a well-capitalized and well-supervised banking system and a good rating for macroeconomic policy.

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<sup>6</sup> For an excellent survey, see Williamson (2000).

<sup>7</sup> For details, see Nunnenkamp (2002b) and the literature given there.

## ***Voting Rights***

The demand of globalization critics to "democratize" the IMF is beside the point if this is meant to go beyond an open dialogue on IMF decisions with interest groups, including NGOs, lacking democratic legitimacy. However, the widely desired "ownership" of IMF programs by developing countries is likely to remain wishful thinking unless these countries have a larger say in IMF decision making. It is hardly disputed that the current distribution of country quotas and voting rights no longer reflects the economic weight of IMF shareholders. Particularly Asian countries appear to be underrepresented (Nunnenkamp 2001: 43).

The suggestions of the Quota Formula Review Group (commissioned by the IMF and headed by Professor Richard Cooper), made in 2000, would do little to shift the balance towards developing countries. More importantly, European governments are strictly opposed to having their overrepresentation reduced in favor of underrepresented developing countries (Fischer 2000). Furthermore, European authorities, including the German Bundesbank, rejected the idea to establish an *independent* IMF Board and insisted on Executive Directors receiving orders from their respective home country (Deutsche Bundesbank 2000). This may come as a big surprise, considering that the Bundesbank (and recently the European Central Bank) always fought for its independence and against political interference. The opposition of major IMF members against an independent IMF Board renders it more difficult for developing countries to make their case.

## **5. SUMMARY**

It is mostly for good reasons that the demands of globalization critics to radically remodel the international financial architecture have been rejected. Completely reversing the process of liberalization may ultimately result in global economic disintegration, which would have by far higher costs than recent financial crises. Yet, market failure in global financial intermediation requires reforms reaching beyond what policymakers have achieved so far.

As concerns financial market regulation, it is not sufficient to overcome distortions embedded in the traditional system of bank supervision and to close regulatory gaps (e.g., regarding HLIs and offshore centers). From a developing country perspective, it is of utmost importance to achieve a better compliance with existing core standards, which may require substantial technical assistance by industrial countries. Furthermore, developing countries should be

aware that regulatory reforms may come at the cost of impairing their access to international capital markets.

Prospects to achieve a fair burden sharing at times of crisis have improved only slightly so far, with some developing countries having agreed with private creditors to introduce collective action clauses in new or restructured debt contracts. After the failure of the initiative by the IMF management to develop international insolvency rules, the open question now is whether collective action clauses will become common practice as a second-best solution.

Conflicting views persist on what the IMF should (not) do in the future. The demands of many IMF critics to strengthen the IMF's social responsibility counteract an economically efficient division of labor with other international financial institutions. In order to refocus the IMF on its original mandate, IMF lending should be limited to short-term emergency loans; conditionality should be restricted to macroeconomic and financial policies and replaced, as far as possible, by pre-qualification criteria.

Last but not least, decision processes at the IMF need to be reformed. It is primarily up to European IMF members to allow for a better representation of developing countries. Moreover, an independent IMF Board would render it easier to ward off political interference by major shareholders. The chances for progress in this regard appear to be particularly bleak, notwithstanding all the cheap talk on ownership of economic adjustment programs by developing countries.

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