# Introduction

Discussion on reform of the international financial system is hardly unprecedented – for instance, it was a recurrent theme during the 1970s, and FONDAD has been engaged in examining such issues for many years. However, the scope of the debate is now broader than ever, as it includes a sweeping re-examination of the costs and benefits of global integration – spanning reform of the architecture of the financial system; the role and governance of key institutions such as the IMF and the multilateral development banks; the world trading system and the WTO; and other elements of an increasingly integrated and globalised system. Concerns about the negative consequences of globalisation were made evident in the recent demonstrations in Seattle, Bangkok, Washington and Prague. The concerns of the protestors reflect a number of real evils that the international system needs to confront.

The globalisation of international capital markets has substantially increased the volume and volatility of private capital movements and the consequent potential of such movements to contribute to sovereign liquidity crises, while complicating their resolution. As the movement of capital responds to sometimes abrupt shifts in market sentiment, countries' increased integration with international capital markets has augmented both the potential magnitude of financing requirements during periods of stress and the pace at which emerging pressures may develop into full-blown crises.

Developing country members of the IMF – especially those from emerging market economies – have increasingly complained during the past two years that decisionmaking in the Fund is dominated by a handful of advanced industrial countries, and that the voices and legitimate interests of developing countries are insufficiently heard.

The international community is absolutely seized, at the moment, with the topic of reforming the international monetary system in the context of a debate over the costs and benefits of globalisation and market-oriented policies. In a way, this is gratifying, because the conclusions of such a loud and visible debate are more likely to be acted upon.

The reflection above is not mine, but that of two prominent IMF officials, Jack Boorman and Mark Allen, made in various sections of their chapter in this volume. Their recognition that a "loud and visible debate" on reform of the global financial system is welcome confirms the need for such reform.



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This book consists of four parts. In the first chapter, in Part I, Stephany Griffith-Jones and José Antonio Ocampo argue that the reform agenda should be broadened to at least deal with two major problems of private capital flows to developing countries: volatility and concentration. To face the problem of volatility, first of all, action is needed by the major industrial countries. According to Griffith-Jones and Ocampo, these countries should take much more account of the "externalities" that their macroeconomic policies generate. But, at the same time, they should also become much more supportive of global regulation of capital flows, timely provision of adequate international liquidity with appropriate conditions when crises emerge, and international arrangements to facilitate orderly debt workouts. To face the problem of the concentration of private flows in a small number of developing countries, official development assistance should be strengthened to fill market gaps in countries and sectors which cannot access private flows. Griffith-Jones and Ocampo concentrate on some aspects of this broader reform agenda. They summarise the problems that the current system faces and use this as a background to analyse the regulatory agenda, both in source and recipient countries, and the issues that relate to the provision of international liquidity and development finance.

The thinking of policymakers in the advanced industrial countries has clearly been influenced by the recent financial turmoil, as the comment by Wouter Raab, a high-level official of the Dutch Ministry of Finance, illustrates: "Having once been an enthusiastic supporter of capital account liberalisation, recent developments have led me to believe that capital account convertibility is not automatically good for every country. In addition to the arguments put forward by Griffith-Jones and Ocampo (consistent and flexible macroeconomic management, adequate prudential regulation and supervision, and well-articulated liability management), I want to mention the size and the development of the domestic capital market. If this market is small in comparison to the size of capital inflows, it would be absolutely incapable of absorbing or dampening any shock from the inflow of foreign capital. It would make the country very vulnerable to the shock-waves coming from the volatile international capital markets. Any country in such a situation would do well to have mechanisms in place to control or regulate the inflow of foreign capital."

The second contribution in Part I comes from two outstanding Korean economists, Yung Chul Park and Yunjong Wang. They emphasise the lack of progress in reforming the international financial system, which they see as the major reason why some East Asian countries have begun to search for a regional defense mechanism. According to the authors, the establishment of a regional credit support mechanism, as proposed in the so-called

Chiang Mai Initiative, might help prevent the recurrence of crises, and will be a more effective mechanism to manage future crises in East Asia. The group of thirteen East Asian countries of the Chiang Mai Initiative (involving the ten members of ASEAN and China, Japan and Korea) commands a large amount of foreign currency reserves estimated at more than $800 billion. "A mere ten percent of the total amount will be sufficient to provide first and second lines of defense against any speculative attack," write Park and Wang. "If the East Asian countries had been able to cooperate to use part of their reserves to supply short-term liquidity to Thailand in 1997, East Asia could have been spared the misery of recession and social dislocation."

Louis Kasekende, deputy governor of Uganda's central bank, also advocates regional cooperation. Although Africa was largely protected from the contagion problems associated with the East Asian crisis, Kasekende observes that African countries are not fully protected from volatility in international financial markets. The reasons are that many countries of the region are influenced by developments in South Africa – creating the likelihood of second-round effects on African countries – and that African financial systems are prone to volatility. "The markets are thin and lack sophistication and flexibility to effectively deal with minor changes in expectations and the switch in demand from domestic to foreign assets and vice versa," writes Kasekende. "There is, therefore, a strong case for monetary and financial cooperation among groups of countries in Africa."

Part II of the book looks at a new framework for private sector involvement in crisis prevention and management. Mark Allen and Jack Boorman examine this topic in the context of the broader effort to improve the functioning of the international financial system. First, they reflect on the globalisation debate and the lessons from recent international financial crises. Second, they review measures that help reduce the incidence and severity of crises, focusing in particular on the IMF's role. Third, they outline the role of the private sector in preventing crises and in contributing, along with the official sector, to crisis resolution. Finally, they consider related reforms of the IMF and other international institutions.

The ensuing floor discussion raises some interesting subjects. Reacting to a remark by Dutch banker Frans van Loon that there has been too little consultation between the public and private sectors, Allen reports on the setting up of a consultative capital markets group that would meet on a regular basis with the Fund management to discuss capital market issues. However, Allen sees a relationship with the private sector that is too close as problematic, because he is concerned that the Fund might look even more like "the pawns of Wall Street" than it already does. Roy Culpeper, president of the Canadian North-South Institute, insists on involving the private sector more in crisis *prevention*. He argues that one should make the private sector less risk prone now rather than waiting until after the crisis breaks out. Amar Bhattacharya, a high-level official of the World Bank, observes that there seems to be an emerging consensus on a number of *ex ante* measures to prevent a financial crisis. They include bankruptcy procedures, collective action clauses, the importance of creditor committees and investor relations, and the development of deep and strong domestic capital markets. Ariel Buira, a former deputy governor of Mexico's central bank, stresses that since crises are part of the essence of market economies, there is a clear need for international rules. Just as every country has *national* legislation for bankruptcies and suspension of payment, there should also be *international* rules to deal with the financial difficulties of troubled debtors.

Part III of the book discusses recent initiatives to improve the regulation and supervision of private capital flows. It includes two chapters, one by Bill White, the chief economist of the Bank for International Settlements in Basel, and another by Yilmaz Akyüz, director of the Division of Globalisation and Development Strategies at UNCTAD.

White reports that recent policy initiatives to regulate and supervise private capital flows have focused on the means to curb possible "excesses" while maintaining or moving carefully towards a regime of free capital flows. He places particular emphasis on evaluating recommendations made recently in various chapters by the Financial Stability Forum (FSF). Four sets of such initiatives are considered in his chapter: those that have to do with transparency (the need for better data, disclosure and indicators of vulnerability); those that have to do with the behaviour of creditors and debtors respectively; and how these recommendations might be implemented in practice.

Akyüz argues that because financial instability is global and systemic there is a need to establish global institutions and mechanisms to improve crisis prevention and management. In his view, the international community has not made much progress in setting up effective global arrangements, concentrating instead on marginal reform and incremental changes. Since the task of protecting themselves against systemic instability falls on developing countries, Akyüz argues that they should seek strategic rather than full integration into the global financial system. He stresses that IMF surveillance has been ineffectual in restraining destabilising influences originating from industrial countries, pointing to the US setting its monetary policy and interest rates regardless of their global impact as a major example.

In the ensuing floor discussion, Bill White agrees with Ariel Buira and Stephany Griffith-Jones that good policies in developing countries often lead to excessive capital inflows. As an example, he refers to Mexico where prior to the crisis of the mid-1990s there was a shift towards fiscal prudence, the signing of the NAFTA treaty and the privatisation of the banking system "along with many other welcome reforms." Another example White mentions is Southeast Asia, where a lot of structural changes were undertaken to open up and improve the economy. According to White, the dilemma for policymakers is how to identify the circumstances in which justifiable optimism turns into excessive optimism, and what to do about it.

Part IV of the book focuses on current proposals to reform the IMF to make it more effective, transparent and accountable. Aziz Ali Mohammed, advisor to the chairman of the G-24, addresses some of the issues that have arisen out of the recent worldwide debates on the future role of the IMF in the wake of its management of the Mexican, Asian, Russian and Brazilian financial crises. Mohammed is not interested in the arguments of people on either the far right or the far left end of the political spectrum who advocate the abolition of the IMF. His interest lies in reviewing the arguments of those who want the Fund to play a constructive role as an international credit cooperative serving its universal membership with impartial macroeconomic policy advice, technical assistance, and financing for countries facing temporary balance of payments problems. In this view, the issue is not how to reduce, but rather, how to enlarge the Fund's role in the global economy. This would, for instance, involve transforming the Fund into a genuine lender of last resort and a creator of international liquidity through its prototype SDR mechanism; an umpire in orderly debt negotiations between private and official creditors and their sovereign debtors; an international authority endowed with powers to declare a "standstill" on legal actions that private creditors might take to enforce their claims on sovereign debtors; and finally, an overseer of the international monetary system through the exercise of effective surveillance over the exchange rate policies of the major international currency countries.

In his comment, Ariel Buira adds another key issue: the far too small size of the Fund is the source of many of the problems that have emerged. One of Buira's main observations is that an international financial system based on the currency of a country that runs large and persistent external deficits, i.e. the US, is doomed to be inherently unstable.

In the final floor discussion, Yilmaz Akyüz argues that there is a need to get back to the drawing board to redefine the role of the Fund. He observes that the international financial system has become a kind of patchwork since the 1960s, creating and continually changing all kinds of mechanisms, facilities and functions in response to events in an *ad ho*c way. Other issues raised include: Should the level of economic and global governance be stepped up rather than down, as has been proposed by the

Meltzer Commission? Should the Fund focus on systemic instability and macroeconomic policy or is the macroeconomic agenda now less important because it is increasingly difficult to narrowly compartmentalise the international agenda?

In the preface to this book, José Antonio Ocampo refers to the Global Financial Governance Initiative (GFGI) of which FONDAD is a part. Besides the GFGI's working group on "Crisis Prevention and Response", from whose first meeting this book results, there are two other working groups, one on "Development Finance" and another on "Institutional Reform". The following pages provide analyses and insights which intend to contribute to the improvement of crisis prevention and response, as well as to the reform of the global financial system.

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