

**Strengthening the Common Financial House<sup>1</sup>**  
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This audience hardly needs to hear yet another proposal for reforming the international financial architecture. There are probably as many proposals as there are people in this room. The Japanese government has one, the German government has one, the Canadian government has one, the U.S. government has one. The Group of 22 released three reports last October on the reform of international financial institutions and arrangements. G-7 ministers then issued a separate declaration about how to renovate the international financial house. George Soros proposes an international debt insurance corporation, Henry Kaufman an international credit-rating agency, Jeffrey Garten an international central bank, Jeffrey Sachs an international bankruptcy court, Stanley Fischer an international lender of last resort. I am reminded of the cover of *The Economist Magazine* last fall, when the crisis was at its peak. It showed a little man — presumably a professor — on the steps of a public building, holding up a sign. “The end of the world is near,” it read. “I have a plan.”

So why another plan, and why now? My answers to both questions are closely related. Existing proposals for reforming the international financial architecture are either singularly unambitious or singularly unrealistic. They either have little significant prospect of strengthening the operation of the international financial system, or little significant prospect of actually being

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implemented. Hence there is a need to stake out the sparsely-populated middle ground.

And why now? Because there are troubling signs that discussion of how to strengthen the international financial architecture is losing steam. There is a growing sense that there exists no consensus about the nature of key reforms. Rightly or wrongly, this is the implication drawn by the press from Secretary Rubin's remarks at Davos last January and from the communique of February's G-7 Summit in Bonn. The following language from a recent issue of *Business Week* is a bit overdrawn, but allow me to read it anyway. In its words, Secretary Rubin "poured cold water over each and every proposal to curb the volatility of global capital markets. Rubin cast a skeptical eye on capital controls, early warning systems, pre-qualification for IMF borrowing, curbing hedge funds, currency target zones, etc. The analysis was coldly brilliant but the accretion of "no's" added up to a virtual veto of any attempt to fix the global financial system — as was seen as such by Europeans, Asians and Americans in the audience." As I say, this language is over-strong, but it makes an essential point. There is a danger of all progress grinding to a halt.

That would be unfortunate and unnecessary. In fact, it is possible, I would insist, to construct a broad-based consensus around an important set of practical, pragmatic proposals for reforming the international financial architecture that will make a difference and actually have a chance of being implemented.

What reforms you find attractive depends on how you diagnose the world's ills. Let me be explicit about how I see the problem. I agree with those who see the Asian crisis as the prototype for future crises. To be sure, some countries will continue to experience crises because they run recklessly expansionary monetary and fiscal policies incompatible with their external

commitments. But these traditional crises respond to the traditional medicine. We know how to diagnose them and how to treat them. With domestic financial liberalization and rising international capital mobility, the problem for the future will be how to cope instead with “high-tech” crises with a dominantly financial as opposed to macroeconomic component — that is, crises associated with weak financial systems, unhedged foreign exposures, unstable short-term debts, and fragile currency pegs. And it is much less obvious how to deal with these financial, as opposed to purely macroeconomic, problems.

I take this as my point of departure because I believe in three fundamental premises. First, financial liberalization — both domestic and foreign — is beneficial. To paraphrase Winston Churchill on democracy, it is the worst system for allocating resources except for all the alternatives. Second, financial liberalization is largely irreversible, as a result of ongoing changes in information and communications technologies and the forward march of securitization. Third, notwithstanding the manifest benefits of financial liberalization, financial markets are prone to overshoot, due to the prevalence of asymmetric information, while coordination problems prevent decentralized markets from quickly disposing of the adverse consequences when they arise. This way of viewing the world points to the need for pragmatic reforms to attenuate information asymmetries and to provide more efficient ways of responding to crises. It does not suggest that there is “a crisis of global capitalism,” or that the system “is coming apart at the seams” (to quote George Soros). It does not suggest that we should throw away the existing system and start over.

Rather, the agenda for reform, as I see it, has four key elements. First, international financial standards, but standards in whose promulgation the private sector takes the lead.

Second, taxes on short-term capital inflows as a form of prudential supervision to stabilize unstable banking systems. Third, more flexible exchange rates to give banks and corporates proper incentives to hedge their foreign exposures, so that they won't be driven into bankruptcy when exchange rates change by an unexpected large amount. And fourth, new provisions in loan contracts to facilitate the orderly restructuring of problem debts by the private sector itself, in order to provide an alternative to devastating defaults on the one hand and ever larger bailouts on the other.

The first element is standards. High capital mobility makes it impossible to fix the international financial system without first fixing the domestic financial systems of countries active on international markets. This is why Martin Feldstein's wishful thinking, that the Fund and the international community more generally should stick to giving advice on monetary and fiscal policies and avoid meddling in the other internal arrangements of countries, is unrealistic. In a world of integrated financial markets, international financial stability is impossible without domestic financial stability. Stabilizing the financial system consequently requires institutional reforms extending well beyond policies toward external trade and payments. That it requires rigorous disclosure requirements and effective supervision of banks and corporations borrowing on financial markets is now acknowledged, courtesy of Morris Goldstein's influential work. Some will argue that this is as far as the international community and the IMF should go in intruding into the internal affairs of countries. I believe that they must in fact go further -- that the need for domestic institutional reforms with implications for the stability of international financial markets extends beyond this point. It extends to the use of internationally-recognized auditing and accounting practices so that lenders can accurately assess the financial condition of the banks and

corporations to which they lend. It extends to effective creditor rights, so that claimants can monitor and control the economic and financial decisions of managers. It extends to investor-protection laws to prevent insider trading, market cornering and related practices in whose absence securities markets will not develop. It extends to fair and expeditious corporate bankruptcy procedures, without which debt problems can cascade from borrower to borrower. If international financial stability is impossible without domestic financial stability, as now seems clear, then these are all problems that the international community will be forced to address. While at the end of the day they may be problems that individual countries will each have to solve in their own way, whether they arrive at an adequate solution is also of pressing concern to the international policy community, given the scope for financial problems to spill contagiously across borders.

Unfortunately, neither the IMF nor any other multilateral agency has the resources to micro-manage this process in 182 countries, or to design regulatory institutions that are sensitive to their different economic, cultural and legal traditions. The only practical approach is to develop and adopt international standards of acceptable practice, not just for bank regulation, as Morris Goldstein has argued, but also for auditing and accounting, corporate governance, and bankruptcy law as well. National practices can differ in their particulars, under this approach, but all must satisfy a common set of international standards.

Responsibility for designing standards cannot be delegated to the multilaterals, which lack the resources and expertise. The lead must be taken by the private sector: by the International Accounting Standards Committee, the International Federation of Accountants, the International Organization of Supreme Audit Institutions, Committee J of the International Bar Association,

and the International Corporate Governance Network. The multilaterals should of course participate in their deliberations. It is important in particular for the Fund to be involved to ensure that it assumes “ownership” of the standards it helps to set.

Promulgating standards is one thing, enforcing them another. Making the markets pay heed will require the IMF to issue blunt assessments of national practice. But lenders having a limited attention span, the IMF will have to reinforce market discipline by offering the carrot of concessionary interest rates on its loans to countries that comply, and by conditioning its programs on steps to bring national practice into conformance.

But there remains the question of whether these incentives will be enough. Only a fraction of IMF member countries is subject to a program at any point in time, and there are good reasons to question whether market discipline will be prompt and systematic in its application. This creates an argument for reinforcing these other incentives to comply by having national regulators key capital requirements for foreign lending to whether the IMF rates the borrowing country as in compliance with the relevant international financial standards. The decennial review of the Basle Capital Accord currently underway is an appropriate occasion for implementing this regulatory discipline.

A second area where a major new initiative is required concerns banks and capital flows. Recent experience has demonstrated too well that badly managed banks and open international capital markets are a dangerously combustible mix. The obvious way of reducing this danger is to strengthen banks’ risk-management practices and supervisors’ oversight and regulation of those practices. Everyone agrees on the need for banks to better manage credit and currency risk, on the dangers of connected lending, on the need to insulate supervisory authorities from political

influence, and on the need to raise bank capitalization as a way of giving bank owners and managers a financial cushion and something to lose. But the sad truth in all too many countries is that banks have a limited capacity to manage risk and that regulators have limited capacity to supervise their actions. In a sense, this limited capacity is the very definition of a financially “underdeveloped,” or “less developed,” or “developing” economy. In such countries, moreover, capital requirements in theory and capital requirements in practice are two very different things, given the inadequacy of auditing and accounting standards. The political realities in many emerging markets are such that bank capital is all too rarely written down. This means that revising the Basle Capital Standards to key capital requirements to the source of banks’ funding as well as the riskiness of their investments is unlikely to prove effective. If bank capital is not written down, in other words, how can capital requirements deter excessive risk taking?

In an environment with these characteristics, free access to foreign finance, short-term finance in particular, is incompatible with financial stability. Foreign funding gives banks gambling for redemption and otherwise seeking to take on excessive risk an additional way to lever up their bets. Government guarantees for banks regarded as too big to fail encourage foreign investors to provide those funds. But a disturbance to confidence may prompt these foreign investors to flee at any time, and the short maturity of their loans provides ample opportunity for them to get out. Their rush for the exits can precipitate a crisis which brings down both the banking system and the currency. This creates an argument for limiting or taxing bank borrowing abroad as a third line of defense against banking-system instability in countries where the first and second lines of defense -- banks’ own risk-management practices and regulatory supervision, respectively -- do not suffice. And where banks can circumvent these

measures by having the corporations do the borrowing and pass on the proceeds to them, broader measures may be required. Financial stability may have to be buttressed by a Chilean-style tax to limit short-term foreign borrowing by all domestic entities.

I argue that the international policy community must become a stronger advocate of these measures. The IMF should make unambiguous its support for the approach. The U.S. Treasury needs to overcome the “Wall Street complex” that renders it reluctant to embrace such policies. Doing so requires that they more clearly articulate the exact circumstances under which such measures are warranted. This means understanding that capital inflow taxes are necessary as a third line of defense against financial instability in countries where the first and second lines of defense — banks’ own risk-management practices and supervision by regulators — are underdeveloped. In practice, this means that they are necessary in most “underdeveloped” countries. With time, of course, underdeveloped countries will develop. Their financial markets will deepen; their macroeconomic and regulatory institutions will grow more robust. With these institutional preconditions in place, they will graduate to the club of mature markets, at which point restrictions on international financial transactions can come off. But until then, cautious steps in the direction of capital account liberalization, which are inevitable given the desire to liberalize domestic financial markets and ongoing changes in information and communications technologies, should not extend to the removal of taxes on capital inflows.

A third important item is changing the provisions of loan contracts. Avoiding both routine rescues and devastating defaults will require creating a more orderly way of restructuring problem debts. Majority voting, sharing clauses, and minimum legal threshold clauses should therefore be added to loan contracts to prevent isolated creditors from resorting to lawsuits and other means



of obstructing settlements, along with collective representation clauses specifying who will speak for the creditors in negotiations. This is the only practical way of creating an environment more conducive to restructuring negotiations, and providing a third way between the two existing, equally unappetizing alternatives of devastating defaults and ever bigger bailouts, with the attendant moral hazard.

Unfortunately, this is a process in which no borrower wants to be first, for fear of sending an adverse signal. The IMF will have to make clear that it will lend at more attractive interest rates to countries that issue debt securities with these provisions. U.S. and UK regulators should require the relevant provisions of international bonds admitted to trading on their markets.

Even together, these measures will not create the ideal orderly-workout system. But they are the only practical alternative to pie-in-the-sky schemes for creating global monetary and regulatory institutions and assuming a political and economic consensus that does not exist. If we wish to create a viable alternative to massive bailouts and devastating defaults, they are the only game in town.

Finally, it is important for aspiring architects to draw the right lessons from the Brazilian debacle. IMF protestations notwithstanding, one indisputable lesson is the need for the vast majority of emerging markets to move to more flexible exchange rates. Brazil illustrates yet again that, in a world of high capital mobility, political democracies cannot credibly attach priority to the maintenance of pegged exchange rates above all other goals of policy. There may be the occasional counterexample like Argentina, where memories of inflation are so searing, but they will always be the exception. How many more demonstrations do we need that capital mobility, political democracy and pegged exchange rates are incompatible, and that it is the pegged rates

that have to give in order to avoid ever more frequent crises?

It is also important to recognize that a new “contingent facility” for the IMF, as suggested by the Clinton Administration and the G7, is not a feasible response. Brazil is a blunt reminder of how few countries have the kind of unquestionably strong policies that might permit the IMF to extend unconditional credits in advance and of how small the Fund’s resources remain relative to those of the market.

These are also grounds for skepticism that the IMF be transformed into a true international lender of last resort. Compared to a national central bank dealing with troubled financial institution, it has less ability to force corrective action on its members. Inevitably this creates moral hazard and raises questions about whether the IMF will get its money back. This is why the Fund is endowed with fewer resources, why it lends less freely, and why it must wait for evidence that policy reforms are in train before releasing each additional bit of finance. It is simply not feasible to ask the IMF to follow Bagehot’s rule of lending freely, against “good collateral,” at a penalty rate.

I am sure that someone in the audience will be quick to remind me of the Argentine alternative — a currency board or even dollarization — if I do not head him off. The single greatest advantage of a more flexible exchange rate, as I have already argued, is that it encourages banks and firms to hedge their exposures. But if the exchange rate is not just pegged but locked in for the duration, it no longer matters whether banks and firms hedge against exchange rate fluctuations because there is a negligible probability that the exchange rate will change. But closing off all avenues for discretionary monetary policy and selling off the banking system to foreigners -- the sine qua non of a currency board -- is the sort of radical amputation of

sovereignty that few societies are prepared to accept. The vast majority of countries consequently have to follow the other alternative of allowing their currencies to fluctuate more freely.

Even if this evolution is inevitable, it will be associated with financial distress, as in Asia, if it is forced on reluctant governments that fail to prepare banks, firms and households for the eventuality. If, on the other hand, the authorities move gradually toward greater exchange rate flexibility while capital is still flowing in, banks and firms will hedge their exposures and not suffer catastrophic losses when the exchange rate moves by an unexpectedly large amount. If the government does not link its entire economic policy strategy to the maintenance of a fixed currency peg but develops a more diversified portfolio of intermediate targets and anchors, it will not lose all credibility when it bows to the inevitable.

Hence, the IMF needs to more forcefully encourage its members to move to policies of greater exchange rate flexibility, the sooner the better. With few exceptions it should pressure its members, in the context of Article IV consultations and program discussions, to abandon simple pegs, crawling pegs, narrow bands and other mechanisms for limiting exchange rate flexibility before they are forced to do so by the markets.

This does not mean that countries which reject the currency board option will have to allow their exchange rates to float freely; they can still intervene in the foreign exchange market to damp temporary fluctuations and limit the volatility that a freely-floating exchange rate entails. What they should not do, by this argument, is commit to an explicit exchange rate target which would force them to issue misleadingly reassuring statements likely to lull banks and firms into a false sense of complacency and set the stage for an ugly crisis. Floating, even dirty floating, is

uncomfortable because of the volatility that it tends to entail; witness the case of Mexico, whose currency declined against the U.S. dollar by more than 20 per cent in the final quarter of 1998. But the Mexican depreciation has not precipitated a crisis. Surely most countries, given a choice between Mexico's situation and the dilemmas of the Brazilian authorities desperately seeking to defend their currency peg, would prefer the former, and with good reason.

Some will say that what I am proposing is a little bit of interior decorating rather than a fundamentally new architecture. If that is your conclusion, then so be it. Realism requires acknowledging, I believe, that there is no willingness to tear down the existing structure because there is no agreement about what radically new edifice to erect in its place. Plans for radical renovations are plans that will never get off the drawing board. But as someone who lives in earthquake country, the need to strengthen the house in which I live by bolting the frame to the foundation is never far from my mind. This is, I think, an appropriate analogy for what national governments and the international policy community must do to strengthen the common financial house.