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**Remarks on the Evolution of
International Financial Architecture**

Managing Risks in the 21st Century

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US Secretary of Treasury Rubin was doubtless not aware when last year he urged a review of the international financial architecture that he was opening a Pandora's Box, unleashing a torrent of metaphors. My remarks will be organized under four architectural headings, ranging from standing pat, to renovating the wiring and plumbing, through replacing the roof and facade, to dismantling the existing structure to the foundation to make room for a new common currency.

I. Standing Pat

A respectable case can be made for no substantial changes in the international financial architecture, merely moving around a bit of furniture. No "architecture" can prevent mistakes being made at the level of the firm or even the state. During the financial crises of the past few years serious mistakes were made, mainly by borrowers and their governments, but also by some lenders. Thailand, for instance, committed three major errors evident to those with only rudimentary knowledge of financial matters: Thai banks borrowed extensively at very short term to lend for urban real estate development; they borrowed extensive amounts of foreign currencies, mainly dollars and yen, to lend against urban real estate with no hope of adequate yields in foreign currency; and the Bank of Thailand continued to support by drawing on foreign exchange reserves an unchanged (dollar) exchange rate even after capital inflows had declined significantly, with no

serious effort to stem in outflow, either through higher interest rates or depreciated currency. These errors together fore-ordained some kind of crisis.

The current architecture, focussed on the International Monetary Fund but with important assistance from the World Bank, the regional development banks, the Bank for International Settlements, and national governments, provides considerable capacity to deal flexibly with problems as they arise. Substantial progress has already been made on accelerating the speed with which the IMF can respond in a true emergency, a significant weakness several years ago. And the recent quota increase and New Arrangements to Borrow have augmented substantially the resources available to the IMF.

The main requirement for coping with crises of the type we have recently experienced is for the major economic entities of the world -- the USA, the European Union, and Japan -- to maintain aggregate demand to set a buoyant tone for the world economy, and to keep their markets open to the products of other countries. Good economic growth and open markets will not prevent crises, but they will ease the adjustment to crises, compared with an environment in which neither condition is met. If both are violated, a financial crisis can become an economic and even a political catastrophe, as it did in the 1930s. At the present time the USA has done very well on this score, and Europe moderately well; Japan has kept its markets open, but is struggling to restore

positive economic growth. The weakness of the Japanese market has seriously compromised the speed of recovery in some Asian economies. Japan's imports from the region and investments in the region are down significantly; and Japan's weak economy has contributed to weak commodities prices, reducing the export earnings of the southeast Asian countries (and Russia), although improving Korea's terms of trade.

II. Renovating the Wiring and Plumbing

Standing pat, while defensible, is perhaps too complacent. The recent mistakes were very costly, both for principals and for their trading partners and competitors through negative spillovers and contagion. We should therefore ask whether some changes in architecture could make the financial system more robust, more resilient and less brittle. At a minimum, we should seize moments of crisis to make improvements in the international financial architecture that should probably be made anyway, but would lack the impetus under normal conditions. This would involve modernizing the plumbing and wiring, as the Dutch IMF Executive Director recently put it, but not replacing the roof and rebuilding the facade. An excellent statement of modest suggestions for improvements can be found in a recent book by Barry Eichengreen (1999).

Included should be adjustments to help prevent future financial crises, improvements in our ability to predict (and hence

forestall or weaken) crises, and improvements in our ability to manage crises once they occur, as they inevitably will.

Under the heading of crisis prevention comes a raft of proposals for improving transparency, corporate governance, government regulation and supervision of financial institutions, and bankruptcy procedures. It may also perhaps entail imposing selective restrictions on capital flows (see Fischer et al.(1998) and Cooper (1999)). These are of course matters for national governments, but the international community can put varying degrees of pressure on national governments to bring their institutions to a higher standard of performance. At a minimum, the international community can disseminate the useful experience of other countries; it could go further and promulgate some general common minimum standards; and it could still further condition IMF lending terms on adoption of common minimum standards.

Under the heading of prediction comes the development of effective early warning indicators, and their use to alert vulnerable countries, and their creditors, to the need for remedial action. Prediction at best is an imperfect art, however, and the world economy is constantly changing, confounding past regularities, as Long Term Capital Management, highly sophisticated at managing risky arbitrage, discovered. Furthermore, widely accepted but imperfect indicators could actually precipitate crises that would not have occurred in their absence. This is a particular problem with the suggestion sometimes made that the IMF

should become a public rating agency for countries, or that it should make public all of its internal analyses.

Under the heading of crisis management come the questions of speed of response, adequacy of resources, and nature of conditionality of international financial support.

A key issue in designing crisis management is the question of moral hazard: work-outs should not be so smooth and successful as to encourage unwarranted risky behavior before a crisis. Moral hazard is an important concept, and indeed moral hazard is always present whenever insurance exists, or is believed to exist. But its importance in recent financial crises has been greatly exaggerated. Countries in trouble typically go to the IMF too late, not too early. Furthermore, most creditors of the troubled countries have suffered substantially, either through losing money or, even when principal has been preserved, through significantly stretching maturities of what were made as short-term loans. Moral hazard can be dealt with adequately by penalizing the parties immediately responsible while protecting the broader financial system.

Another key issue in designing crisis management is whether and if so how best to handle outstanding debt, and in particular how best to mobilize private creditors quickly and effectively to provide a breathing space for smooth post-crisis adjustment. Suggestions include introducing majority clauses into bond covenants (so a majority of bondholders can act for all

bondholders, preventing free-rider hold-outs), and stand-still provisions in interbank loans, triggered by certain specified conditions (e.g. by the IMF). Such provisions would certainly raise the cost of borrowing, and discourage some lenders. That would not necessarily be a bad thing. But the problem of the next few years is likely to be too little capital flowing to problem countries, not too much.

III. Providing a New Roof

Constructive suggestions proposed under the previous heading largely fall into the range of sensibly tweaking the international financial system, not fundamental change. One could go a step further and convert the IMF into a world central bank. That would in principle involve it in a direct role in global macro-economic management, not the main issue here (see Cooper, 1987); it would also involve converting the IMF into a true lender-of-last-resort, which it is not at present because of its reliance on member states to provide it with adequate resources. Fischer (1999) suggests that the IMF should move in this direction, and indeed that it has already undertaken many of the relevant functions. But he does not address the question of permanent resource adequacy. The IMF today can issue an international currency, SDRs, to make up any shortfall in the secular growth in world reserves, a judgement that is made every five years. The IMF Articles could however be amended to allow it to issue SDRs quickly in periods of financial emergency,

under carefully drawn terms of reference that define both the conditions for activation and the conditions for retirement. The classical conditions for action by a lender-of-last-resort to banks, laid down by Walter Bagehot in 1873, is that in emergency it should stand ready to lend without limit, at a penalty rate, against good collateral (as priced in normal times), and make this readiness known ahead of time. These actions are to assure adequate liquidity in a financial system, not to bail out insolvent banks, which requires a different course. But dealing with insolvent institutions is much easier in a favorable financial environment than in one seized up for lack of liquidity.

With the ability to use SDRs, the IMF would never be short of resources in serious financial crises, and could concentrate all its attention on the conditions under which those resources would be made available, instead of having to worry also about creating a coalition of willing new lenders in each case. IMF conditionality provides a functional substitute for collateral, although the pledging of collateral by states, as was done by Mexico against the US Treasury loan of early 1995, should not be excluded.

Moral hazard could be reduced not only by the stringent conditions, but also by a number of the measures mentioned under the previous heading, such as conditioning the terms of IMF lending on prior acceptance of internationally-agreed standards, and the presence of "bail-in" clauses in international loan covenants.

This change would represent a substantial restructuring of the current international financial architecture, renovation of the exterior as well as the plumbing and the wiring (which would also be desirable -- this bold action would not be a substitute for most of the suggestions under the previous heading).

IV. Starting Over

Maybe the current international financial architecture is structurally flawed, and cannot be rescued in the long run. Ultimately the structure may have to be taken down and rebuilt entirely. There is a fundamental question whether full freedom of capital movements can co-exist with diverse national currencies, floating one against another. (We already know that full freedom of capital movements is not compatible with currencies with fixed but adjustable exchange rates; they invite speculative movements, and provide a one-way option for profits to prospective speculators, which of course include residents as well as foreigners.)

A country's exchange rate in principle equilibrates its total demand and supply of foreign exchange, which in a world of high capital mobility is dominated in the short and medium run by movements of capital; but for most countries the exchange rate is also an important determinant of the level and structure of prices of goods and services. High exchange rate variability may be inconsistent with efficient production of goods and services, which

is the prime determinant of a people's economic well-being. High price variability may also detract from a sense of well-being, apart from any negative impact on real consumption. If so, many countries may have to choose between restricting the international movement of capital, assuming that can be effectively done, and tying their currencies irrevocably to some important currency, via currency boards or even adoption of the more important currency. That represents a narrow menu for most countries, and their choice is one of strategic importance. A reasonable forecast is that there will be, practically speaking, fewer national currencies 25 years hence than there are today.

Moreover, even large countries may find their domestic production unnecessarily disrupted by large movements in exchange rates, driven by capital transactions. The exchange rate between the currencies of the world's two largest national economies, Japan and the United States, moved by 70 percent (between ¥85/\$ and ¥145/\$) within the course of three years. Both countries had low inflation and disciplined fiscal policies. That cannot be the product of a well-functioning international monetary system, and it threatens liberal trade policy, in the first instance through the (mis)use of anti-dumping rules.

Floating exchange rates, which have often successfully cushioned national economies against external shocks, may increasingly become a source of transmission of shocks originating in world financial developments. They may transmit (financial)

shocks with a frequency and magnitude that grows over time relative to their ability to cushion (real) shocks. This development is especially likely to occur if, as some expect (e.g. Bergsten, 1997, 1999; Portes and Rey, 1998), the new euro develops a substantial international role quickly, making it a viable substitute for the dollar and thus generating potential instability in portfolios around the world. If so, floating exchange rates would become increasingly unsatisfactory, even among major countries. The major industrial democracies should therefore begin thinking about the implications of adopting and managing a common currency (as suggested in Cooper, 1984), just as the European countries have done within Europe.

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