

# Describe the Major Proposals to Revise the International Financial Architecture to Limit the Frequency and Severity of Financial Crises in Developing Countries in the Future

Written by Charlotte Ng

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CHARLOTTE NG, JUN 19 2008

The devastating financial crises that have hit developing nations in Latin America and Asia over the past several decades have given rise to numerous rallying calls to reform the “international financial architecture.” Liberalizing the financial system to foreign capital flows have contributed to immense domestic political and economic turmoil, and in some nations even to violence. Not unexpectedly given the complex nature of financial crises, the proposed reforms have been just as divergent as the diagnoses of factors culminating to the crises.

To begin with, the conception of “financial architecture” is elastic depending on different groups. To financiers and institutional investors, reform of the financial architecture means the implementing a global consensual standard on best practices in financial reporting. To Japan and Western Europe, reform means that the U.S. should engage in multilateralism in responding to global financial crises. To the U.S., it means trimming of the International Monetary Fund and the World Bank. To finance ministers in developing countries and emerging markets, reform of the global financial architecture means debt forgiveness for highly indebted poor countries and the creation of a global lender of last resort better-funded than the IMF. In her essay “The Political Geography of World Financial Reform: Who Wants What and Why?” Leslie Elliot Armijo defines the global financial architecture as “an international regime,” signifying a “set of principles, norms, rules, and procedures in an international issue arena” (Armijo 2001: 380). The international financial architecture comprises of a set of multilateral agreements and understandings, both formal and implicit, among core capitalist states, about the rules and norms that govern cross-border financial transactions. (Armijo 380).

The current debate over reforms takes place in the context of the post-Bretton Woods era, marked by floating exchange rates for the major powers, fewer controls on private capital movements, and moves towards multilateral regulation. Armijo divides those who call for reform into four broad positions: the laissez-faire liberalizers, transparency advocates, financial stabilizers, and antiglobalizers. The laissez-faire liberalizers advocate for free capital markets at the global level, as they view markets as autonomous and require only good information flow and reputation to inhibit unethical behaviour (383). Transparency advocates, who dominate mainstream forums and study commissions, view that the inadequacy of domestic institutions and inappropriateness of national policies of countries hit by financial crisis have made them susceptible. The third group, financial stabilizers, see the global financial architecture as the source and solution for financial crises. Capital markets are not self-equilibrating and need careful oversight and prudential regulation (385-6). Armijo herself sides with the financial stabilizers in their solution for the prevention and management of banking and currency crises. The final group is the antiglobalizers, who prefer isolationist policies and oppose global capitalism (387-8).

Revision of the international financial regime concerns the institutions and norms surrounding 1) exchange rate practices, 2) regulation of cross-border financial flows, and 3) management of international financial institutions (IFIs). The four groups diverge on these issues based on differences in their political and economic understanding.

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On global exchange rate practices, there are different camps within the laissez-faire group: some wish to revert back to the gold standard to impose fiscal and monetary discipline on governments and to sidestep the imposition of trade and capital controls; others advocate for floating exchange rates, trusting the foreign exchange market to punish profligacy. Transparency advocates blame financial crises on flaws in the national regulatory frameworks, and do not take a specific position on a desired exchange rate regime, as the problems lie inherently in the emerging market countries themselves. Likewise, antiglobalizers make no clear contribution to the exchange rate practices debate.

Financial stabilizers, viewing that global finance requires global regulation, favour seeing an actively and collaboratively managed float among the core powers, arguing that floating exchange rates, while inevitable at least at the regional level, are hardly self-equilibrating. Some advocate regional currency blocs. Consistent with this perspective are economists Steve Hanke, who supports dollarization and currency boards, and Benn Steil, who goes further to promote the complete abolishment of the national currency and official adoption of a regional currency.

In his essay "On Dollarization and Currency Boards: Error and Deception," Steve Hanke argues that the current debate on currency boards suffers from semantical problems and the empirical evidence on which economic and political analyses are based has been limited. According to Hanke, the characterization of monetary authorities in economies such as Hong Kong and Argentina as currency boards is in fact dubious, as the laws governing these arrangements deviate in many important respects from currency board orthodoxy. These governing laws are flawed as they allow monetary and exchange rate policies to conflict with one another, which could contribute to balance of payment crises often associated with pegged exchange-rate regimes (Hanke 204-5). In practice, these monetary arrangements may be characterized as "currency board-like systems." Although Hanke concedes that these systems have produced relatively good macroeconomic results, evidenced by real GDP growth, low inflation, and contained fiscal deficits, they have not been trouble-free, notably in the case of Argentina. Hanke points out that every time Argentina deviated further from currency board orthodoxy, it fuelled devastating speculation against the peso; and when orthodoxy was embraced, speculative pressures faded out (211). In 2001, Domingo Cavallo, the newly appointed economy minister, took measures that dismantled convertibility and compromised confidence and credibility. In this way, Cavallo destroyed what Hanke would consider a robust—though not orthodox—currency board-like system, and instead created a "financial and economic fiasco of the first order" (211).

In his case for adopting orthodox currency boards, Hanke discusses his personal experience as counsellor to Suharto's government in Indonesia during the Asian crisis. Following a severe and rapid plunge of the rupiah's value in 1998, Hanke prescribed the creation of an orthodox currency board. During the period in which the markets perceived that a currency board would be adopted, the rupiah strengthened dramatically against the US dollar in the spot market. Volatility also fell significantly during this period. Hanke asserts "these objective market data indicated that market participants judged the currency board proposal credible" (Hanke 2001: 218). Alleged political machinations aside, as in the case of Indonesia, Hanke points out that the IMF has been a staunch supporter of currency boards in economies even less mature than Indonesia's, all of which, as reported by the IMF, have seen inflation and interest rates fall, real growth turn positive, and banking systems strengthen.

In "The End of National Currency," Benn Steil goes beyond Hanke and advocates for official dollarization and abolishment of the national currency. Steil disagrees with Joseph Stiglitz and other supporters of monetary nationalism, maintaining that economic development outside the process of globalisation is no longer possible and capital flows become destabilizing only after countries begin asserting sovereignty over their currencies. He uses the oft-cited example of Argentina, whose government abandoned the currency board entirely in 2002 when it ran out of U.S. dollars to back its peg, and subsequently lapsed back into statist economic control, its economy still fragile as ever before. Steil holds that the problem lies in the notion of national currencies itself. Since the abandonment of the gold standard in 1971, global trade has been intermediated by fiat monies, with people willing to hold only a handful of currencies such as the dollar and the euro. Many developing countries are dependent on U.S. dollars for long-term credit; at the first sign of devaluation, both locals and foreigners will sell off the local currency en masse, avalanching into further speculation and full-blown currency crisis. As such, Steil believes that governments should replace their currencies with the dollar or euro, or, in the case of Asia, a new multinational currency. Within a currency bloc, capital flows will become seamless. Although dollarizing countries must give up independent monetary policy, the act of dollarization alone would effectively lower interest rates and inflation to levels of those of the issuing country,

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essentially achieving the goals of monetary policy. In this way, speculation can be avoided, enabling safe and rapid integration of smaller and poorer countries into global financial markets.

The caveat to this proposal, however, is that the dollar is ultimately not gold; rather, it is backed by the faith of people. Unfortunately, the U.S. current account deficit, fuelled by an enormous fiscal deficit, is compromising the dollar's position as a privileged currency and undermining the faith foreigners have in its management. The U.S. needs to return to more prudent money policies lest dollar-rich countries start to balk. Furthermore, Steil does not specify whether the regional currencies should float freely or be managed to some degree, as speculation could still occur on a regional basis. The nationally different banking supervision and regulatory standards within blocs would remain vulnerable to speculative flows.

A second major area for reform in the international financial architecture concerns the regulation of cross-border financial flows and the debate between those advocating capital controls and those advocating capital account liberalisation. These are not binary, but are matters of degree. Opponents of controls are laissez-faire liberalizers and transparency advocates, as termed by Armijo. The proponents of capital controls are the financial stabilizers, as they view that preemptive capital controls are necessary, particularly on short-term, inward flows.

Subscribing to a similar school of thought are Robert Wade and Frank Venerosso. In their article, "The Gathering World Slump and the Battle over Capital Controls," the authors blame the capital account liberalisation undertaken in the 1990s for the enormous destabilizing whipsaw in capital flows in Asia in 1997-98. Wade and Venerosso raise Malaysia as an example of capital controls working effectively to respond to crisis. The exchange controls prevented speculation by requiring exporters to sell their foreign exchange to the central bank at a fixed rate; that currency was then sold for approved payments to foreigners. These controls did not extend to foreign direct investments, or to current account transactions (Wade and Venerosso 21). Economist Paul Krugman wrote that temporary exchange controls were necessary to allow Asian governments must lower interest rates and push fiscal expansion. In a similar vein, former Fed Chairman Paul Volcker said that the IMF's pro-capital account liberalization stance left many small economies dangerously exposed to turbulent capital flows (28). Wade and Venerosso argue that some forms of capital controls are necessary in Asia: semi-permanent controls are needed to protect against excessive inflows, specifically against short-term financial capital. Asia has the highest savings rates in the world and does not need short-term foreign finance capital. Capital controls are needed to make these small, open economies less vulnerable to the stampedes of portfolio fund managers. Unfortunately, Wade and Venerosso's article presents a rather one-sided argument against capital account liberalisation and fails to address its potential benefits, such as increasing portfolio diversification, improving economic freedom, and increasing competition. They also ignore the important issue of sequencing, which amplifies the complexity and uncertainty in the liberalisation process. Furthermore, the authors are so focused on demonising the IMF that they ignore any rationale behind the IMF programme, as well as the European origin of the liberal international financial regime, citing problems as essentially the products of the Wall Street-IMF-Treasury complex.

In his book, *Capital Flows and Crises*, Barry Eichengreen presents a much more comprehensive, balanced assessment of the economic case for and against capital controls. The case for financial liberalisation draws on the basic economic insight that markets allocate resources in a socially desirable ways. While they may not work perfectly, they produce better results than heavy-handed bureaucratic control. Domestic and international financial liberalisations go hand-in-hand—it is hard to liberalise domestic transactions while retaining international controls. International financial transactions improve the global allocation of capital, help economies offset business-cycle disturbances, and allow investors to diversify away country-specific risk. Opening capital accounts is the culmination of the process of developing a deep, mature, and efficient domestic financial system. Some also argue that capital controls infringe on the civil liberty of residents: citizens in Malaysia cannot take more than \$100 out of the country since the controls were in place. (Eichengreen 281-282)

But as history has shown, markets can also be dangerously unstable. Bank assets are less liquid than their liabilities. They hold more information about the credit worthiness of their clients than do outsiders, hence to raise funds in a crisis they must sell assets at fire-sale prices, damaging their balance sheets. Furthermore, because banks do extensive business with each other, a sudden loss of confidence can produce a contagion. In the securities markets,

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investors have imperfect information and infer information about the value of their investments from the action of others, resulting in herding behaviour. Emerging markets may be at risk of being destabilized by a small number of hedge funds conscious of one another's action. Investors also take position on credit; when the market moves against them, they are often forced to sell in a falling market to put up additional capital. A large price fall can bring bank and nonbank intermediaries down with it, which disrupts the supply chain of credit in the economy. As such, capital controls can be justified on prudential grounds where financial markets are thin and conventional defenses (e.g. regulation and risk management) against systemic risk are not adequate. For emerging markets, therefore, an open capital account should be the exception. With time, developing countries will develop. Ultimately, the best solution is not to impose capital controls but to eliminate the fundamental problems leading to the excesses in monetary and fiscal policy in the first place, such as credibility problems with the central bank and fiscal laxity of the government. (286)

Belonging to the financial stabilizer group, Eichengreen takes the "messy middle" stance: capital account liberalisation can increase vulnerability, but crises are not entirely arbitrary; therefore one needs to find the right balance between risk and reward. He stresses the importance of sequencing. Liberalisation should not precede the recapitalisation of the banking sector and strengthening of prudential regulation. Once the domestic financial market is ready, FDI should follow, then stock/bond markets, and finally offshore bank borrowing. Emerging markets should rely on market-friendly instruments, rather than bureaucratic administration, for managing the capital account. A good example is Chile's 30% non-interest-bearing deposit for a year for all capital imports. Problems of capital mobility and dangers associated with precipitous capital account liberalisation should be acknowledged at the global level. While the U.S. has grown more sympathetic towards the use of capital-import taxes, Eichengreen argues that further is required and the U.S. Treasury needs to overcome the "Wall-Street complex." Finally, there should be initiatives to install renegotiation provisions into foreign loan contracts as a way of facilitating orderly workouts so as to eliminate the use of international assistance to prop up shaky currency pegs.

The third major issue for debate in the international financial architecture relates to the management of global and domestic financial institutions. At both extremes, laissez-faire liberalisers and antiglobalizers would close the World Bank and International Monetary Fund. Transparency advocates, believing that financial crises stem from 'homegrown' factors of inadequacy of the domestic institutions and unsuitable national policies. Ignoring the contagion effects of global trade and investor herding, this group attributes "structural" flaws of poorly capitalized banks and crony capitalism as the roots of the Asian financial crisis in 1997-98. As a result, transparency advocates' recommendations are to improve regulation, such as through tightening international lending standards, and transparency, through more accurate, open financial reporting by governments and firms in developing countries (Armijo 384).

Financial stabilizers are much more sensitive to the global distribution of power and make the unequal distribution of costs among the victims of financial crises central to their analysis. In addition, financial stabilizers unwilling to force national policymakers to subordinate the maintenance of domestic macroeconomic health to the goal of external balance, especially when the causes of external imbalances are largely exogenous. They call for more transparent rules for allocating credits from IFIs such as the IMF and World Bank, even suggesting a global bankruptcy court, making the IMF into a formal lender of last resort and global credit rating agency (386). Consistent with this view, Padma Desai, author of *Financial Crisis, Contagion, and Containment: From Asia to Argentina*, argues that the IMF should increase the amount of financial support with a view to softening the "fiscal-cum-monetary pressure" on a country in financial trouble. Alternatively, it should change its outdated policy templates and introduce innovations that are customised to the unique needs of a troubled emerging market economy, becoming a "genuine multilateral agency with a diversified policy agenda" (Desai 2003: 236). Reforming the IMF involves a departure from its ideological insistence on free capital mobility, towards the ability to orchestrate orderly debt settlement and effective fiscal management in order to instil investor confidence (237).

There are several reasons for subscribing to the financial stabilizers' school of thought for revising the international financial architecture. First, it is widely accepted that domestic financial markets, in particular the banking industry perform better when regulated. By what logic, as Armijo asks, are international financial markets different? Prudential regulation therefore should be implemented on an international level as well. Second, financial stabilizers incorporate

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the goal of maximizing world allocative efficiency. Prudential regulation would protect developing countries from unanticipated financial crises of external origin, and in turn lower the barriers that are currently in place to limit direct investments by rich countries, hence increasing global efficiency. Finally, only the financial stabilizers advocate for a well-funded international lender of last resort, which is necessary to prevent crises of liquidity from turning into crises of solvency (Armijo 389-90). The key to reforming the global financial architecture is to recognise that an equally global financial regulation is needed, transcending beyond the often ad hoc solutions coming from the greater capitalist states when a crisis arises.

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*Date written: 2007*