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THE INTERNATIONAL FINANCIAL ARCHITECTURE

WHAT'S NEW? WHAT'S MISSING?

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PETER B. KENEN

INSTITUTE FOR INTERNATIONAL ECONOMICS
WASHINGTON, DC
NOVEMBER 2001

For
Jacques de Larosière
with admiration and affection

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Preface

The functioning and reform of the international monetary system have been among the central foci of the Institute for International Economics since its creation in 1981. Our very first publications, by Senior Fellow John Williamson, included *The Lending Policies of the International Monetary Fund* (1982) and *IMF Conditionality* (1983). Most recently, Dennis Weatherstone Senior Fellow Morris Goldstein directed the Council on Foreign Relations' Independent Task Force Report on *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (September 1999) and Barry Eichengreen authored *Toward a New International Financial Architecture: A Practical Post-Asia Agenda* (February 1999). Specialized aspects of the topic have been addressed in *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option* (September 2000) by Williamson and in *Assessing Financial Vulnerability: An Early Warning System for Emerging Markets* (June 2000) by Goldstein, Graciela Kaminsky, and Carmen Reinhart.

This new study traces the evolution of the debate on the international financial architecture through the middle of 2001. In addition to analyzing the substance of the key reform issues, it describes the evolving attitudes of the major players—the finance ministries and central banks of the most important countries, the relevant international institutions, and the private groups and individuals that have participated in the debate. It also draws attention to the interplay between the course of the debate and lessons learned from the currency crises of the late 1990s. Finally, it attempts to explain the outcomes, or absence thereof, on the various issues being debated, and to explain what remains to be done to solidify the system's

defenses against future crises and its ability to respond effectively to those crises that do occur.

Professor Peter B. Kenen of Princeton University is one of the most eminently qualified observers to conduct such a study. He has been among the most perceptive and innovative analysts of international monetary affairs for over 40 years, including during several stints in the recent past as an adviser to the US Treasury. He was for many years the director of the International Finance Section at Princeton. His *Essays in International Finance* and other publications have been one of the leading sources of wisdom on these topics.

The Institute for International Economics is a private nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute is funded largely by philanthropic foundations and private corporations. Major institutional grants are now being received from the William M. Keck, Jr. Foundation and the Starr Foundation. A number of other foundations and private corporations contribute to the highly diversified financial resources of the Institute. About 31 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 18 percent from Japan. The Rockefeller Brothers Fund provided generous support to this project.

The Board of Directors bears overall responsibilities for the Institute and gives general guidance and approval to its research program, including the identification of topics that are likely to become important over the medium run (one to three years), and which should be addressed by the Institute. The Director, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. Fred Bergsten
Director
October 2001

Acknowledgments

In the autumn of 1995, I began to serve as a consultant to the US Treasury and continued in that position for four years, working largely on issues relating to the reform of the international financial architecture. Soon thereafter, Fred Bergsten invited me to distill my own views on that subject, and this book is the result. Readers will soon see that I disagree with some of the Treasury's decisions and views. Nevertheless, I am deeply indebted to the officials who took time to discuss the issues with me, especially Jeffrey Shafer, David Lipton, Timothy Geithner, and Caroline Atkinson. I am also indebted to fellow members of the Group of Thirty, the Task Force on the Future International Financial Architecture sponsored by the Council on Foreign Relations, and the Bellagio Group of officials and academics, which discussed the issues intensively.

I owe an equally large debt to the members of the study group convened by the Institute of International Economics to review the manuscript and to all of the readers of the manuscript who took time to write out their comments and suggestions—Alan Blinder, Ralph Bryant, Bill Cline, Jerry Cohen, Barry Eichengreen, Tim Geithner, Ellen Meade, Brad Setser, Jeff Shafer, Ted Truman, and John Williamson.

I am indebted to Patrizia Baudino for producing the charts and to Kathleen Hurley for preparing the final version of the manuscript under very tight time constraints. I am also indebted to the Institute's publications staff, especially Brigitte Coulton, Madona Devasahayam, and Marla Banov.

My work on this book began in the spring of 2000, when I was a visiting scholar in the Centre for Economic Performance at the London School of Economics, and I am grateful to Richard Layard for that opportunity.

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Acronyms

BCBS	Basel Committee on Banking Supervision
BIBF	Bangkok International Banking Facility
BIS	Bank for International Settlements
CCL	Contingent Credit Line
CFF	Compensatory Financing Facility
CFR	Council on Foreign Relations
CPSS	Committee on Payment and Settlement Systems
ECB	European Central Bank
EFF	Extended Fund Facility
EFM	Emergency Financing Mechanism
EMS	European Monetary System
ESF	Exchange Stabilization Fund
FATF	Financial Action Task Force
FSA	Financial Sector Assessment (World Bank)
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSSA	Financial Sector Stability Assessment (IMF)
GAB	General Arrangements to Borrow
GDDS	General Data Dissemination Standard
GDP	Gross Domestic Product
GKO	The Russian language abbreviation for Russia's treasury bill
HIPC	Highly Indebted Poor Countries
IAIS	International Association of Insurance Supervisors
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFIAC	International Financial Institution Advisory Commission
IIF	Institute of International Finance

IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
IOSCO	International Organization of Securities Commissions
LIBOR	London Interbank Offered Rate
LLR	lender of last resort
NAB	New Arrangements to Borrow
NAFTA	North American Free Trade Agreement
NAMU	North American Monetary Union
OECD	Organization for Economic Cooperation and Development
PRI	Partido Revolucionario Institucional (Institutional Revolutionary Party)
ROSC	Report on the Observance of Standards and Codes
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Right
SRF	Supplemental Reserve Facility
UDROP	Universal Debt Rollover Option with a Penalty
WTO	World Trade Organization

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Introduction

Speaking at the Brookings Institution in April 1998, Robert Rubin, the US secretary of the treasury, explained the need to strengthen the "architecture" of the international financial system (Rubin 1998). Although he gave a new name to that need, it had been identified three years earlier, shortly after the Mexican crisis of 1994-95, when the governments of the major industrial countries proposed a number of reforms aimed at preventing future crises and resolving more effectively the crises that do occur. This book describes the evolution of that reform effort. It explains how the challenges posed by the emerging-market crises of the late 1990s affected the course of the architecture exercise and how the exercise itself affected the ways in which the official community sought to resolve those crises. It also proposes further changes in the international financial architecture intended to strengthen the financial systems of emerging-market countries, limit the use of large-scale official financing, and foster the involvement of private-sector creditors in the resolution of financial crises.

The Origins of the Architecture Exercise

The Mexican crisis of 1994-95 is discussed fully in chapter 2, along with the Asian crisis of 1997-98. But a brief account must be given here to explain the origins of the architecture exercise.

The Mexican crisis began in March 1994, when capital inflows came to a sudden stop after the assassination of Luis Donaldo Colosio, presidential candidate of the Partido Revolucionario Institucional (PRI), the leading

political party. Betting on an early resumption of those inflows, the Mexican authorities declined to take corrective action—to tighten monetary policy or devalue the peso. But subsequent capital inflows were too small to cover the country's large current account deficit, and Mexico's reserves began to fall. To limit the loss of reserves, the Mexican government issued large quantities of *tesobonos*, short-term debt instruments repayable in pesos but indexed to the US dollar. In September 1994, however, a second assassination—this time of the PRI's secretary general—was followed by a sharp drop in the Mexican stock market and more reserve losses. The newly elected Mexican government therefore sought to engineer a modest devaluation. On 20 December, it widened the band within which the exchange rate was allowed to fluctuate. But the peso fell promptly to the weak edge of the band, and Mexico's reserves were too small to defend it. The Bank of Mexico had to let the peso float, and it depreciated rapidly, losing half its dollar value in less than two weeks.

At that point, Mexico's currency crisis turned into a debt crisis. The depreciation of the peso implied a huge increase in the dollar value of the outstanding *tesobonos* and thus jacked up the budgetary cost of redeeming them. Had investors been willing to roll them over, the immediate budgetary burden—the increase in the peso value of the interest payments on the *tesobonos*—might have been manageable. But Mexico could not readily redeem the whole stock of *tesobonos* and could not possibly convert the pesos paid to holders of maturing *tesobonos* into US dollars. Hence, investors were unwilling to roll over their holdings.

Early in 1995, the US Treasury sought congressional support for financial assistance to Mexico, but that effort failed. Faced with the rising risk of a Mexican default, not unlike the one that touched off the debt crisis of the 1980s, the US Treasury and the International Monetary Fund (IMF) assembled $50 billion of official financing, including $20 billion from the US Exchange Stabilization Fund (ESF) and $18 billion from the IMF itself. The package made it possible for Mexico to redeem the whole stock of *tesobonos*—which is precisely what it did during the next several months. The Fund's contribution to the package was the largest in its history, more than twice as large as the normal limit on a member country's *cumulative* use of IMF resources. For its part, Mexico adopted a set of policy changes aimed at cutting the current account deficit in 1995 and reducing the inflation rate to single-digit levels by 1997.[1]

Although it averted a damaging default, the Mexican "bailout" was severely criticized. It was seen by some to increase moral hazard, because debtors and creditors might conclude that they would not be penalized for making mistakes. It was seen by some to be unfair, because it protected

1. On the failed attempt to obtain congressional support for unilateral US assistance to Mexico and details of the subsequent financial package, see Henning (1999); on Mexico's policy changes and the markets' response, see Leiderman and Thorne (1996).

from losses one class of investors—those who had bought *tesobonos*—but not investors who had bought Mexican equities and other peso-denominated claims.[2] And it was widely seen as a worrisome precedent, even by those who endorsed it, because the IMF did not have sufficient financial resources to offer large-scale assistance to other crisis-stricken countries.

At the Halifax Summit in June 1995, the governments of the G-7 countries[3] sought to address these objections. They called for measures to reduce the risk of future crises and for steps to strengthen the IMF itself—to augment its resources and improve its procedures—in order to deal decisively with those crises that could not be prevented. The Halifax communiqué (Group of 7 1995) made several recommendations.

In aid of crisis prevention, an "early warning system" should be developed, based in part on strengthened IMF surveillance and the disclosure of more information to market participants. To this end, the IMF should establish benchmarks for the timely publication of economic and financial data and should identify publicly those countries that adopt them. It should also provide sharper policy advice to individual governments and deliver franker messages to those that appear to be avoiding necessary actions.

In aid of crisis resolution, official financing should be made available quickly in amounts sufficient to manage shocks effectively. The IMF should therefore design an Emergency Financing Mechanism (EFM) to provide faster access to Fund financing when crises occur and should make larger up-front disbursements in such situations. To backstop these efforts, the network of credit facilities available to the Fund, the General Arrangements to Borrow (GAB), should be doubled in size by raising the lending commitments of existing participants and adding new participants.

The Halifax communiqué also called for further work on two broad issues. First, it asked that efforts be made to safeguard the financial system by strengthening international cooperation in supervising financial institutions and markets. Countries should still be encouraged to remove capital market restrictions, but the international financial institutions

2. In Washington, moreover, critics charged that the Treasury's use of the ESF defied the intent of Congress, which had refused to endorse unilateral US assistance to Mexico. Congress responded by restricting subsequent use of the ESF for loans to foreign governments. As the restrictions were still in force in mid-1997, the United States could not contribute significantly to the financial package assembled for Thailand in July 1997. But they expired later that year, allowing the United States to contribute to the financial packages for Indonesia and Korea.

3. The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The G-10 countries, mentioned below, actually total 11; they comprise in addition Belgium, the Netherlands, Sweden, and Switzerland.

should help them design appropriate supervisory structures. Second, it called for a review of the legal and other issues posed by debt crises—issues made more complex in the 1990s by the large number and heterogeneity of the private-sector creditors that could be involved in a crisis. Third, it called for an examination of "other procedures" to aid in the orderly resolution of future debt problems.[4]

Some of these recommendations were implemented rapidly. The IMF was quick to adopt an EFM to foster prompt and continuing consultations between the Fund's management and its Executive Board during discussions with governments that have an unusually urgent need for IMF assistance—consultations that had been short-circuited during the Mexican crisis. The Fund also began to develop statistical standards to foster prompt publication of economic and financial data: a Special Data Dissemination Standard (SDDS) for countries that participate in global capital markets and those that aspire to do so, and a less demanding General Data Dissemination Standard (GDDS) for all other countries.

By the end of 1996, moreover, agreement had been reached on a scheme to augment the credit facilities available to the IMF. Instead of enlarging the GAB, a group of 25 countries, including several emerging-market countries, agreed to surround the GAB with another network of credit facilities: the New Arrangements to Borrow (NAB). The GAB remains in place, but the NAB is now the Fund's primary source of credit.[5] The Fund's managing director can ask for activation of the NAB when the IMF requires supplementary resources "to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system" (IMF 1999g, 455).

The request for new work on financial stability and the supervision of the financial system did not lead quickly to visible results, but the issue was not dropped. At the Lyon Summit in 1996, the G-7 governments called for "maximum progress" on three fronts:

- enhancing cooperation among the authorities responsible for the supervision of internationally active financial institutions, importantly by clarifying their roles and responsibilities;
- encouraging stronger risk management and improved transparency in the markets and connected activities, especially in the innovative markets;

4. The reference to "other procedures" was, I am told, intended to express guarded interest in the proposal by Sachs (1995) for an international bankruptcy regime to deal with sovereign debt problems.

5. The decision to create the NAB, not enlarge the GAB, addressed the concern of some G-10 governments that adding new participants to the GAB would dilute their control over its use.

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