TASK FORCE REPORT

SAFEGUARDING PROSPERITY IN A GLOBAL FINANCIAL SYSTEM

THE FUTURE INTERNATIONAL FINANCIAL ARCHITECTURE

REPORT OF AN INDEPENDENT TASK FORCE
ONSORED BY THE COUNCIL ON FOREIGN RELATIONS

ARLA A. HILLS AND PETER G. PETERSON, CO-CHAIRS
MORRIS GOLDSTEIN, PROJECT DIRECTOR

Safeguarding Prosperity in a Global Financial System

The Future International Financial Architecture

Report of an Independent Task Force
Sponsored by the Council on Foreign Relations

Carla A. Hills and Peter G. Peterson, Co-Chairs
Morris Goldstein, Project Director

A Council on Foreign Relations-Sponsored Report
Published by the
Institute for International Economics

The Council on Foreign Relations, Inc., a nonprofit, nonpartisan national membership organization and think tank founded in 1921, is dedicated to promoting understanding of international affairs through the free and civil exchange of ideas. The Council's members are dedicated to the belief that America's peace and prosperity are firmly linked to that of the rest of the world. From this flows the Council's mission: to foster America's understanding of other nations—their peoples, cultures, histories, hopes, quarrels, and ambitions—and thus to serve our nation through study and debate, private and public.

THE COUNCIL TAKES NO INSTITUTIONAL POSITION ON POLICY ISSUES AND HAS NO AFFILIATION WITH THE U.S. GOVERNMENT. ALL STATEMENTS OF FACT AND EXPRESSIONS OF OPINION CONTAINED IN ALL ITS PUBLICATIONS ARE THE SOLE RESPONSIBILITY OF THE AUTHOR OR AUTHORS.

The Council will sponsor an Independent Task Force when (1) an issue of current and critical importance to U.S. foreign policy arises, and (2) it seems that a group diverse in backgrounds and perspectives may, nonetheless, be able to reach a meaningful consensus on a policy through private and nonpartisan deliberations. Typically, a Task Force meets between two and five times over a brief period to ensure the relevance of its work.

Upon reaching a conclusion, a Task Force issues a report, and the Council publishes its text and posts it on the Council's website. Task Force Reports can take three forms: (1) a strong and meaningful policy consensus, with Task Force members endorsing the general policy thrust and judgments reached by the group, though not necessarily every finding and recommendation; (2) a report stating the various policy positions, each as sharply and fairly as possible; or (3) a "Chairman's Report," where Task Force members who agree with the Chairman's Report may associate themselves with it, while those who disagree may submit dissenting statements. Upon reaching a conclusion, Task Forces may also ask individuals who were not members of the Task Force to associate themselves with the Task Force Report to enhance its impact. All Task Force Reports "benchmark" their findings against current administration policy in order to make explicit areas of agreement and disagreement. The Task Force is solely responsible for its report. The Council takes no institutional position.

For further information about the Council or this Task Force, please write the Council on Foreign Relations, 58 East 68th Street, New York, NY 10021, or call the Director of Communications at (212) 434-9400. Visit our website at www.cfr.org.

Printed in the United States of America.

FOREWORD

No event of the past 50 years has generated more calls for a reexamination of the institutions, structures, and policies aimed at crisis prevention and resolution than the Asian/global financial crisis that began in Thailand in July 1997. In September 1998, following a speech he delivered at the Council on Foreign Relations, President Clinton underscored this theme when he suggested that it would be worthwhile to convene a distinguished private-sector group to take a fresh look at the need for reform of the international financial architecture.

The Council was therefore enthusiastic about sponsoring this Independent Task Force on the Future International Financial Architecture. We were fortunate that Peter G. Peterson, chairman of both the Council and the Blackstone Group and secretary of commerce during the Nixon administration, and Carla A. Hills, CEO of Hills & Co. and US Trade Representative during the Bush administration, agreed to serve as co-chairs. We chose Morris Goldstein, a widely respected former deputy director of research at the IMF and now a senior fellow at the Institute for International Economics, to be the project director and to author the report. We also invited a stellar group of economists, bankers and financial experts, industrialists and labor leaders, political scientists, strategists, and regional specialists to join the task force. Suffice it to say that it would be difficult to assemble a group that could match for breadth and depth of experience on international financial policies the membership of this task force. The Council wishes to thank them all for their time and contributions.

The task force met regularly from January through June 1999. The first set of meetings focused on what was "broken" in the existing architecture, and the last set on how to "fix" it. Both moderate and more radical reform proposals were considered. In addition to its internal debates, the Task Force benefited from discussions with current and former economic policymakers. In this connection, the task force is especially indebted to Michel Camdessus, Andrew Crockett, Stanley Fischer, Tim Geitner, Alan Greenspan, William McDonough, Robert Rubin, George Shultz, and Larry Summers for sharing their views on the architecture. Likewise, the task force appreciates the valuable reactions and suggestions it received last April in a meeting with a group of central bank governors and finance ministers from a set of larger emerging economies and industrial countries.

In this final report, the task force argues forcefully that despite the sorry track record on banking, currency, and debt crises of the past twenty years, it would be a counsel of despair to conclude that little can be done to make crises less frequent and less severe. With the US economy now connected much more closely to the rest of the world than it was two or three decades ago, a strengthening of the international financial architecture is also very much in our national interest. The US economy performed impressively throughout the latest crisis because domestic spending was strong and inflation was low. Next time, we may not be so well positioned to weather the storm.

The task force favors a market-oriented approach to reform that would create greater incentives for borrowing countries to strengthen their crisis prevention efforts and for their private creditors to assume their fair share of the burden associated with resolving crises. This would place the primary responsibility for crisis avoidance and resolution in emerging economies back where it belongs: on emerging economies themselves and on their private creditors, which dominate today's international capital markets.

Notwithstanding some dissents on specific findings and proposals, all 29 members of the task force endorse the broad thrust of this report. Seven key recommendations were able to command majority support:

1. *Greater rewards for joining the "good housekeeping club."* The IMF should lend on more favorable terms to countries that take effective steps to reduce their crisis vulnerability and should publish an assessment of these steps so the market can take note.

2. *Capital flows—avoiding too much of a good thing.* Emerging economies with fragile financial systems should take transparent and nondiscriminatory tax measures to discourage short-term capital inflows and encourage less crisis-prone, longer-term ones, like foreign direct investment.

3. *The private sector: promote fair burden-sharing and market discipline.* All countries should include "collective action clauses" in their sovereign bond contracts. In extreme cases where rescheduling of private debt is necessary, the IMF should provide financial support only if debtor countries are engaged in "good faith" rescheduling discussions with their private creditors, and it should be prepared to support a temporary halt in debt payments. The IMF should also encourage emerging economies to implement a deposit insurance system that places the main cost of bank failures on shareholders and on large, uninsured private creditors—not on small depositors or taxpayers.

4. *Just say no to pegged exchange rates.* The IMF and the Group of Seven leading industrial countries should advise emerging economies against adopting pegged exchange rates and should not provide funds to support unsustainable currency pegs.

5. *IMF crisis lending: less will do more.* For country crises, the IMF should adhere consistently to normal lending limits and should abandon huge rescue packages. For systemic crises that threaten the international monetary system, the IMF should turn to its existing credit lines when problems are largely of the country's making and to special contagion funds when the country is an innocent victim.

6. *Refocus the IMF and the World Bank: back to basics.* The IMF should focus on monetary, fiscal, exchange rate, and financial sector policies, not on longer-term structural reforms. The World Bank should focus on longer-term structural and social aspects of development, not on crisis management or macroeconomic advice.

7. *Generate political support for and ownership of financial reforms.* A global conference of finance ministers should convene to reach a consensus on priorities and timetables for specific actions that countries will take to strengthen national financial systems.

The task force's reform agenda is more ambitious than that being pursued by policymakers at present. It is tougher in the measures it proposes to reduce moral hazard and to induce private creditors to accept their fair share of the burden of crisis resolution. It is clear on the need for the IMF to return to more modest rescue packages for country crises and to activate very large rescue packages only in systemic cases with the agreement of a supermajority of creditor countries. It is stronger in its opposition to pegged exchange rates and more forthright in proposing tax measures to shift the composition of capital inflows to longer-term, less crisis-prone elements. It is more activist in urging the IMF to identify publicly which countries are and are not meeting international financial standards. It asks more of the major industrial countries in leading the way toward certain institutional reforms in capital markets. It calls for a stricter demarcation of responsibilities and leaner agendas for the IMF and the World Bank. And it suggests a vehicle for garnering political support and for regaining the momentum toward architectural reform.

As the Council forwards this report, we hope that it will contribute to the ongoing debate on how best to strengthen the international financial architecture. The more successful we are in that endeavor, the better are our chances of safeguarding America's jobs, savings, and national security as well as of promoting global prosperity.

Leslie H. Gelb
President
Council on Foreign Relations

ACKNOWLEDGMENTS

This final report represents a substantial amount of work and cooperation on the part of many individuals.

The task force's co-chairs, Carla Hills and Pete Peterson, were instrumental both in putting this diverse and talented group together and in keeping the group focused on its objectives and timetable. They contributed valuable suggestions and ideas, which are reflected in the task force's recommendations. They also made my job immeasurably easier by giving me enough room for maneuver to organize the task force's deliberations and to draft the final report in the way I thought best, and by providing encouragement when it was most needed.

I am also indebted to the members of the task force. They couldn't have been more helpful in sharing their views and ideas and in making suggestions on several previous drafts. While there was a lot of spirited debate during the task force meetings, that debate always took place in a constructive spirit (and with a lot of good humor). It was a pleasure to be a part of it.

I would also like to thank The Starr Foundation for its generous financial support of this project. At the Council, Les Gelb and his colleagues aided our work at every stage of the project. Special thanks go to Betsy Cohen, Tracey Dunn, David Jones, and April Wahlestedt. We could not have completed this report within such a short time frame without the wide-ranging and consistent support of Les and his team.

Finally, a few words of appreciation to my home institution, the Institute for International Economics. There, I want to thank Director C. Fred Bergsten for granting me leave from my normal Institute responsibilities to serve on the Council's task force, Kara Davis, John J. Guardiano, and Christine Flint for doing their usual first-rate job in getting the manuscript ready for publication, and Trond Augdal for superb research assistance.

Morris Goldstein
Project Director

CONTENTS

EXECUTIVE SUMMARY

INTRODUCTION

When Thailand was forced to devalue its currency in July 1997, no one could have foreseen the turmoil that would follow. Over the succeeding two years, *financial crises swept through the developing world like a hurricane.* Indonesia, South Korea, Malaysia, the Philippines, Hong Kong, Russia, and Brazil were among the hardest hit, but few developing countries emerged unscathed. *In the crisis countries, currencies and equity prices plummeted, economic growth turned into recession, wealth evaporated, jobs were destroyed, and poverty and school dropout rates soared.* Private capital flows to emerging economies nose-dived, while industrial countries saw their export markets shrink. Last fall, after Russia's debt default and devaluation and the near collapse of a large hedge fund (Long Term Capital Management, LTCM), international financial markets seized up for nearly all high-risk borrowers, including those in the United States. *Global growth slowed sharply.* In some quarters, doubts arose about the market as the engine of prosperity. Confidence in the official institutions that manage financial crises was shaken. No wonder, then, that *President Clinton,* speaking before the Council on Foreign Relations a year ago, *characterized the Asian/global crisis as "the greatest financial challenge facing the world in the last half century."*

Financial crises are nothing new. In the past 20 years alone, more than 125 countries have experienced at least one serious bout of banking problems. In more than half these episodes, a developing country's entire banking system essentially became insolvent. And *in more than a dozen cases, the cost of resolving the crisis*

Certain passages in the executive summary are italicized to highlight the task force's main findings and recommendations.

was at least a tenth—and sometimes much more—of the crisis country's annual national income. As bad as it was, the US savings and loan crisis of the late 1980s cost US taxpayers about 2-3 percent of our national income. The debt crisis of the 1980s cost Latin America a "lost decade" of economic growth. Ten members of the European Exchange Rate Mechanism were forced to devalue their currencies in 1992 and 1993, despite spending upwards of $150 billion to defend them. Mexico suffered its worst recession in six decades after the devaluation of the peso in 1994-95. *And in the recent Asian crisis, economies accustomed to annual growth rates of 6-8 percent suffered severe depressions, with output falling 5 to 14 percent last year.* In the past six months, a number of the crisis countries have returned to positive economic growth and the functioning of global financial markets has improved. But *the global recovery is still in its early stages and remains fragile*—not least because most of the underlying vulnerabilities have been only partly addressed.

We cannot eliminate banking, currency, and debt crises entirely, but it would be a counsel of despair to argue that little can be done to make them less frequent and less severe. *Strengthening crisis prevention and management—that is, the international financial architecture ("the architecture" for short)—is also very much in our national interest. The US economy is connected much more closely to the rest of the world than it was 20 or 30 years ago.* The average share of exports and imports in our national output now stands at about 15 percent—twice as high as in 1980 and three times as high as in 1960. Two-fifths of our exports go to developing countries. US firms active in global markets are more productive and more profitable than those that serve only domestic customers. *Exporting firms pay their workers better and have expanded jobs faster than firms that do not export.* More than $2.5 trillion of US savings is invested abroad. Borrowing costs, including the monthly payments US households make for their home mortgages, are lower because of our participation in international capital markets.

But why worry, some might ask. After all, *the US economy has continued to perform impressively throughout the latest crisis* period. So it has. But to conclude that fragilities in the international financial system are somebody else's problem would be dangerously complacent. In the recent emerging-market crisis, *US exports to the most affected areas fell 40 percent. The Asian crisis struck when domestic spending in the United States was robust and when inflationary pressures were low.* This meant that our economic growth was able to withstand a big jump in the trade deficit and that the Federal Reserve had scope to calm the turbulence in global markets by cutting interest rates. *Next time we might not be so well positioned to weather the storm.*

We should also take note of events that did not happen but could have. Americans have more of their wealth invested in the stock market than they have in their homes. The Asian crisis could have acted as a catalyst for a significant stock market correction.

The United States is not immune to financial crises abroad. There have been enough losses, close calls, and "might-have-beens" over the past few decades to remind us that international capital markets—despite their important contribution to our standard of living—can at times be risky places. *The more successful we are in reducing the frequency and severity of financial crises—including in emerging economies—the better are our chances of safeguarding America's jobs, savings, and national security as well as of promoting global prosperity.*

OUR APPROACH

If we are *to make real headway in improving crisis prevention and management in the developing world, we must put the primary responsibility back where it belongs: on emerging economies themselves and on their private creditors, which dominate today's international capital markets.* If the behavior of debtors and creditors does not change, the poor track record on financial crises will continue. But wishing for change will not make it happen. *Better incentives—including the prospect of smaller and less frequent official bailouts—can facilitate desirable changes in lender and borrower behavior.*

Six principles guided our analysis. We wanted to:

1. Encourage emerging economies to intensify their crisis prevention efforts.
2. Permit savings to flow to the countries and uses where they have the best return.
3. Promote fair burden-sharing among private creditors, official debtors, and official creditors when a crisis does occur.
4. Increase the role of market-based incentives in crisis prevention and resolution.
5. Make reform of the architecture a two-way street, with the major industrial countries also doing their part.
6. Refocus the mandates of the IMF and the World Bank on areas they are best equipped to address.

Consistent with these principles, *we offer seven key recommendations:*

Recommendation 1. Greater rewards for joining the "good housekeeping club." The IMF should lend on more favorable terms to countries that take effective steps to reduce their crisis vulnerability and should publish assessments of these steps for each country so the market can take note.

Recommendation 2. Capital flows—avoiding too much of a good thing. Emerging economies with fragile financial systems should take transparent and nondiscriminatory tax measures to discourage short-term capital inflows and encourage less crisis-prone, longer-term ones, such as foreign direct investment.

Recommendation 3. The private sector: promote fair burden-sharing and market discipline. To encourage more orderly and timely rescheduling of private debt where it is needed, all countries should include "collective action clauses" in their sovereign bond contracts. In extreme cases where rescheduling of private debt is needed to restore a viable debt profile, the IMF should require as a condition for its own emergency assistance that debtors be engaged in "good faith" (serious and fair) discussions on debt rescheduling with their private creditors. The IMF should also be prepared to support a temporary halt in debt repayments.

To reduce moral hazard at the national level, the IMF should encourage emerging economies to implement a deposit insurance system that places the primary cost of bank failures on bank shareholders and on large, uninsured private creditors of banks—and not on small depositors or taxpayers.[1]

Recommendation 4. Just say no to pegged exchange rates. The IMF and the Group of Seven (G-7) should advise emerging economies against adopting pegged exchange rates and should not provide funds to support unsustainable pegs.

Recommendation 5. IMF crisis lending: less will do more. For country crises, the IMF should adhere consistently to normal lending limits. This will help to reduce moral hazard at the international level. For systemic crises, the IMF should turn to its existing credit lines when problems are largely of the country's making and to special contagion funds when the country is an innocent victim.

Recommendation 6. Refocus the IMF and the World Bank: back to basics. The IMF should focus on monetary, fiscal, and exchange rate policies plus financial-sector surveillance and reform and stay out of longer-term structural reforms. The World Bank should focus on the longer-term structural and social aspects of development, including the design of social safety nets. It should stay out of crisis lending and management.

Recommendation 7. Generate political support for and ownership of financial reforms. Convene a global conference of finance ministers to reach a consensus on actions, priorities, and timetables for actions nations will take to strengthen national financial systems.

---

[1] By "moral hazard," we mean situations in which the availability of insurance from the official sector weakens investors' and borrowers' sense of responsibility for their own actions.

THE REFORM AGENDA

Recommendation 1. Greater Rewards for Joining the "Good Housekeeping Club"

Emerging-market economies have a key responsibility to keep their houses in order, and the international community can encourage them to do so by enlarging the rewards for good housekeeping.

"Good housekeeping" covers a range of economic policies and institutional reforms. It means pursuing sound macroeconomic policies, including the avoidance of large budget deficits. It means prudent debt management that does not permit liquid liabilities of the public and private sectors to get way ahead of their liquid assets and that discourages the buildup of large currency mismatches. It means not being complacent about large current account deficits and highly overvalued exchange rates. It means maintaining a strong and well-regulated banking and financial system that extends loans on the basis of their expected profitability and of the creditworthiness of the borrower, and that complies with international standards for good public disclosure of economic and financial data, for effective banking supervision, and for the proper functioning of securities markets. It means shunning heavy reliance on short-term borrowing and on longer-term debt contracts with options that allow the creditor to demand accelerated repayment if conditions worsen. And it means holding enough international reserves and arranging contingent credit lines so that there is enough liquidity on hand to cushion against unexpected adverse shocks.

Suffice it to say that *many of these elements of good housekeeping were not in order in the run-up to recent crises.* In Russia and Brazil, for example, large government deficits and heavy reliance on short-term government borrowing were at the heart of their vulnerability.

In the Asian crisis countries, imprudent debt management, weak domestic banking systems, and premature and poorly supervised financial liberalization took a heavy toll when the external environment soured. Encouraged by interest rates lower abroad than at home, by exchange rates that had been relatively stable with respect to the US dollar, and by a history of strong economic growth, banks and corporations in the crisis countries stepped up their short-term foreign borrowing in the 1990s, much of which had to be repaid in foreign currency. On the eve of the crisis, short-term external debt was larger than international reserves in several of the crisis countries, and corporations had very high debt-to-equity ratios. Banks and finance companies in these countries had lax lending and accounting standards. Their lending decisions were also compromised by heavy government interference and by high levels of "connected" lending (to bank managers and directors and their related businesses). Bank supervision was weak. Reflecting all this, borrowed funds were not invested wisely, with heavy concentrations in real estate, equities, and industries with low rates of return. Lenders (domestic and foreign) did not monitor borrowers carefully, perhaps because they expected that governments and international organizations would be willing and able to bail them out if borrowers ran into trouble.

And run into trouble they did. Exports from Asia slowed dramatically in 1996, prompted by a steep decline in semiconductor prices and a loss of competitiveness as Asian currencies followed the US dollar up against the Japanese yen. Property prices fell, leading to a surge in nonperforming bank loans. As foreign lenders began to recognize that Thailand's weaknesses were shared by several other Asian emerging economies, a panic ensued in which foreign shareholders, bondholders, and banks scrambled to get their money out. Cash flow problems mounted as interest rates rose in vain attempts to defend currencies pegged to the dollar. Political instabilities and uncertainties added to the problem. And when currencies fell sharply, this made it much more expensive for companies to repay their foreign currency loans. Soon everything collapsed.

Henceforth, the IMF should lend on more favorable terms to countries that take effective steps to reduce their vulnerability to crises. To increase the private market payoff for good crisis prevention, the IMF should make public a "standards report" in which it assesses periodically each member country's compliance with international financial standards. It should also publish its *regular assessments of each country's economic policies and prospects (its Article IV reports). Loans to countries that make the extra crisis prevention effort should benefit from lower regulatory capital requirements for banks. Some initial, partial, and tentative steps in this general direction have already been made, but more should be done to strengthen the rewards for joining the "good housekeeping club."*

Recommendation 2. Capital Flows—Avoiding Too Much of a Good Thing

The freer flow of capital across national borders has been of considerable benefit to the world economy. It has loosened the constraints imposed by self-financing and improved the overall productivity of investment on a global scale. This finances development and raises living standards in borrowing countries while providing savers in lending countries with the opportunity to earn a better return on their money. It has permitted both borrowers and investors to obtain better diversification against shocks to their domestic economies. It has helped foster the transfer of best-practice production processes.

But experience indicates there are risks and costs along with the benefits. In recent years, private capital flows into emerging markets have been highly volatile. After mushrooming in the early 1990s, they reached a peak of $213 billion in 1996, before collapsing to just over $60 billion last year. This volatility shows up in price as well as quantity. During the 1990s, the interest rates paid on emerging-market bonds have fluctuated wildly in comparison with those paid on US bonds. For example, this interest rate spread was 1,200 basis points in January 1991; 400 points in January 1994; 1,600 points in January 1995; 400 points in mid-1997 (just before the Asian crisis began); 1,400 points in the fall of 1998 (just after Russia's debt default); and 1,100 points in July 1999.[2]

While some fluctuation in private capital flows to emerging economies is natural in light of changing investment opportunities and the way investors react to new information, experience sug-

[2]A basis point is equal to one-hundredth of a percent; for example, the difference between a 10 percent and 11 percent interest rate is 100 basis points.