

# Rebuilding the International Financial Architecture

## *Emerging Markets Eminent Persons Group Report\**

### FOREWORD

*by Dr. Il SaKong*

**W**aves of financial crises in emerging markets during recent years have given rise to widespread calls for a new 'international financial architecture' that would allow global capital markets to function properly and ensure global financial stability.

A number of distinguished expert groups have recently addressed these issues and have put forward valuable proposals for reforming the international financial architecture (IFA). However, these reports primarily reflect the views of G7 industrialised countries without reflecting the views of emerging markets, although emerging markets are most vulnerable to international financial instability and are most directly affected by the proposed institutional and regulatory arrangements.

With the support of the Ford Foundation, a group of experts from emerging markets has been established to gather consensus views among themselves regarding major issues for reforming the IFA. The Group first met in Seoul, Korea on 9-10 November, 2000, where critical issue areas were identified and discussed among EMEPG members together with leading experts as resource persons. The second meeting was held in Santiago, Chile on 7-8 March, 2001, where a preliminary report was prepared based on discussions among EMEPG members. The final meeting took place in New York, USA on 3-4 May, 2001, where the preliminary report prepared in Santiago was closely reviewed. The views of the EMEPG members who

could not attend these meetings were incorporated in the draft through communication.

The Emerging Markets Eminent Persons Group (EMEPG) is made up of the following independent senior personalities:

Il SaKong (chairman)	Korea
Edmar Bacha	Brazil
Kwesi Botchwey	Ghana
Solita Collas-Monsod	Philippines
Ruth de Krivoy	Venezuela
Mar'ie Mohammed	Indonesia
Jaime Serra-Puche	Mexico
Manmohan Singh	India
Noordin Sopiee	Malaysia
Chalongphob Sussangkarn	Thailand
Roberto Zahler	Chile

The Group invited world-renowned experts regarding these issues to join the Advisory Board for the project, which was composed of:

C. Fred Bergsten	USA
Rolf Luders	Chile
Ronald McKinnon	USA
Ernest Stern	USA
Joseph Stiglitz	USA
Paul Volcker	USA

The advisory board members were invited to attend the EMEPG's New York meeting, where they provided their comments and participated in the discussions.

\* This is the Executive Summary of the Emerging Markets Eminent Persons Group Report on "Rebuilding the International Financial Architecture" which was published by the Institute of Economics, Seoul, South Korea in October 2001, with a foreword by Dr. Il SaKong, Chairman and CEO of the Institute of Global Economics and Chairman of the Emerging Markets Eminent Persons Group.

Professor Valpy FitzGerald of the University of Oxford, who participated in the project as a rapporteur and resource person, drafted the report. The secretariat was provided by the Korea Institute for International Economic Policy (KIEP) and led by Dr. Yunjong Wang.

The EMEPG is naturally concerned with the role of emerging market economies in establishing new international financial architecture. In particular, despite the fact that most of the officially proposed changes to the existing system mainly affect emerging markets, the governments of these countries have not formed part of the bodies that have been mainly responsible for formulating these international norms. The Group is also concerned that stances taken by the G7 countries on their domestic financial, monetary or fiscal policies may have major externalities which destabilise emerging markets despite their best efforts to maintain sound economic policies. The orderly functioning of the global capital and currency market as a whole is central to both the short-term stability and sustainable growth of emerging markets.

The main aim of the Group has been to address the international financial architecture. In consequence, our Report focuses on international financial issues rather than domestic policy reform.

Where we do discuss national policies, it is mainly in the context of the international norms or actions that constrain government actions. This focus in no way implies that emerging market governments have no responsibility for instability: in many cases there is still much to be achieved before sound fiscal, monetary and regulatory positions are reached. However, there is clearly an incomplete international agenda to which this Group attempts to contribute.

In the light of these considerations, the Report makes a total of thirty-three recommendations for the consideration of the international policy-making community, which relate to the eight topics that constitute its separate chapters.

The views contained herein represent those of the EMEPG in general. Although not all members are in full agreement with all details of the report, they support the general thrust of the report and the logic of the recommendations. It also has to be mentioned that although the Advisory Board members were asked to review the report and share their valuable opinions, the views contained herein are solely of the EMEPG and do not necessarily reflect the views of the Advisory Board or any of its members.

## EXECUTIVE SUMMARY

A central characteristic of the world in the twenty-first century is the increasingly free movement of goods and services across national boundaries. It is now generally agreed that the integration of middle-income developing countries (the 'emerging market countries') to global capital and currency markets can lead to increased access to a larger savings pool, the transfer of modern technologies and the opportunity to diversify risk. This integration thus forms part of the economic strategy of almost all countries, although the potential gains must be set against the risk of exogenous shocks transmitted from international markets that can destabilise emerging markets, with profound economic and social consequences.

The first half of the 1990s saw a massive expansion of private financial flows from developed to developing countries, which was widely welcomed as a positive contribution to development. However, the second half of the 1990s revealed that these private flows could be easily reversible, as a succession of financial crises in emerging markets seriously set back important progress in economic growth and poverty reduction. The opening months of the twenty-first century have seen remarkable recuperation of production levels in some emerging markets but continued financial vulnerability in others, while contagion still appears to affect

international investors and global capital markets are conditioned by uncertainty as to G3 growth prospects.

Financial fragility in many emerging market economies has been exacerbated in the past by poor corporate governance in (domestic) financial institutions and corporations (both state-owned and private), inadequate financial regulation and supervision, weak institutions and insolvent fiscal systems. Much progress has been made – often under adverse circumstances – to correct these deficiencies by almost all emerging market governments in recent years. However, stronger prudential standards, sound macroeconomic fundamentals, enhanced risk management and improved transparency, although necessary, are not sufficient to provide an assurance of market stability. International action on a coordinated basis is clearly also required.

A number of distinguished expert groups have recently addressed these issues and have put forward valuable proposals. However, these reports primarily reflect the views of G7 industrialised countries, despite the fact that emerging markets are the most vulnerable to international financial instability. With the support of the Ford Foundation, a group of independent and authoritative persons from emerging markets has thus been established to gather consensus views among themselves regarding major issues for reforming the 'international financial architecture' (IFA). The Emerging Markets Eminent Persons Group on International Financial Architecture is thus composed of

eleven senior private figures from emerging market countries. The Group also invited six leading international experts regarding these issues to join the Advisory Board for the project.

The Group is naturally concerned with the role of the emerging market economies in establishing new international financial architecture. In particular, despite the fact that most of the officially proposed changes to the existing system mainly affect emerging markets, the governments of these countries have not formed part of the bodies that have been mainly responsible for formulating these international norms. The Group is also concerned that stances taken by the G7 countries on their domestic financial, monetary or fiscal policies may have major externalities which destabilise emerging markets despite their best efforts to maintain sound economic policies. The orderly functioning of the global capital and currency market as a whole is central to both the short-term stability and sustainable growth of emerging markets.

The main aim of the Group has been to address the international financial architecture. In consequence, our Report focuses on international financial issues rather than domestic policy reform. Where we do discuss national policies, it is mainly in the context of the international norms or actions that constrain government actions. This focus in no way implies that emerging market governments have no responsibility for instability: in many cases there is still much to be achieved before sound fiscal, monetary and regulatory positions are reached. However, there is clearly an incomplete international agenda to which this Group attempts to contribute.

In our Report, we discuss eight key topics grouped in three issue areas. First, how emerging market countries should best manage their integration into global financial markets so as to ensure stability and growth; and how best this integration might be supported by the international institutions and the policies of G7 countries themselves. This area includes the speed and sequencing of *capital account liberalisation* and the choice of appropriate *exchange rate regime*. Second, how the inter-governmental regulatory regimes affecting international banks, bond and equity funds and other financial intermediaries can support emerging markets, and by extension global financial stability. This area includes the *regulation of highly leveraged institutions (HLIs)*, the setting of *international financial codes and standards*, and *private participation* in crisis prevention and resolution. Third, how institutions at the international, regional and country level can best be adapted in order to reduce social cost of financial instability and develop a system of global monetary and financial governance appropriate for the changed global financial market. This area includes *social protection mechanisms* for financial stability, the *reform of international financial institutions (IFIs)*, and *regional monetary and financial co-operation*.

In the light of these considerations, the Group has made a total of thirty-three recommendations for the consideration of the international policy-making community, which relate to these eight topics.

### **The Speed and Sequencing of Capital Account Liberalisation**

We urge emerging market governments to adopt appropriate sequencing, pace and scope of capital account liberalisation. After all, capital account liberalisation is not an end in itself, but a means to sustained higher growth.

Prior actions that should be undertaken before liberalizing the capital account include not only fiscal and monetary discipline and trade liberalisation but also measures to attain a private sector savings-investment balance and prudential regulation of bank and non-bank financial intermediaries.

Governments should not be prevented from using market-based instruments (such as transaction taxes or reserve requirements) on short-term capital flows in order to prevent disruptive capital inflows that threaten effective domestic monetary policy and raise the probability of sudden reversals of capital flows. However, such instruments should be used as a temporary safeguards.

Emerging markets should encourage longer maturities on private capital inflows, and discourage short-term borrowing by domestic firms. Banks should be regulated to avoid unmatched and unhedged currency exposure in their balance sheets. Foreign direct investment should be encouraged as it combines long maturity with other benefits such as risk sharing and technology transfer.

Emerging economies should be cautious in internationalising their currencies as offshore markets can be used for speculative activities that can destabilise vulnerable financial systems. Countries should apply an integrated set of rules and regulations to prevent an overly active offshore market for domestic currencies, with the support of international authorities where appropriate.

### **The Choice of Appropriate Exchange Rate Regimes**

The international financial community should acknowledge the systemic problems faced by countries whose financial markets are still at an intermediate stage of development and not sufficiently integrated to global markets to rely on permanent access to private financing. The choice of exchange rate regime in order to avoid misalignment should be left to the government. This choice should not be constrained by international financial institutions to the 'corner' options of a permanently fixed parity or a free float.

An 'intermediate' exchange rate regime may well be preferable in practice for countries trading worldwide and subject to external financial shocks. This intermediate exchange rate regime may need to be supported by market-based intervention instruments or other appropriate regulations in order to contain speculative attacks.

The wide swings of dollar/yen/euro exchange rates are one of important sources of external shocks to emerging market economies, undermining their efforts to maintain sound financial policies and macroeconomic balances. We strongly urge the G3 countries to develop a system by which stable exchange rates among major currencies be maintained.

### **The Regulation of Highly Leveraged Institutions**

Although the use of modern financial instruments such as derivatives can help develop emerging markets, they can also be a destabilising factor in times of economic stress. It is thus urgent that the G7 governments adopt the proposals of the Financial Stability Forum for indirect regulatory measures to be applied to Highly Leveraged Institutions.

In particular, it is important for G7 supervisors to regulate bank lending to HLIs in order to reduce their ability to mount speculative attacks on emerging markets. The timely disclosure of the uncovered positions of large hedge funds and the proprietary trading desks of global banks would also assist in this aim.

G7 governments should encourage their financial supervisors to share appropriate information regarding financial intermediaries under their supervision with emerging markets' regulatory authorities. By creating mechanisms for effective information sharing, G7 supervisors could effectively monitor the overall size of creditors' exposure to HLIs.

### **Setting International Financial Codes and Standards**

There is an evident need for emerging market authorities to apply sound regulatory standards, both to ensure the integrity of their own financial markets and to gain sustained access to international capital markets. However, these codes and standards must be flexible in terms of both their timing and their scope. Prior implementation of a single set of 'core' codes and standards should thus not be made a condition for support from the international financial community – such as pre-qualification for contingent credit lines.

This flexibility is required in order to permit adaptation to the specific characteristics of emerging market economies. It is necessary to focus on those aspects of the Financial Stability Forum proposals (such as transparency and timely reporting) needed to ensure access to private capital markets.

The international bodies concerned with global financial standards (the Financial Stability Forum in particular) must adequately represent emerging market

authorities because it is these economies where the proposed codes and standards will have most impact.

The G7 governments and the international financial institutions themselves should provide resources and technical assistance to support emerging market governments without sufficient domestic implementation capacity.

The revision of the Basle Capital Accord on bank supervision needs a particular attention paid not to shorten the maturity of private bank lending to emerging markets.

The G7 should take steps towards ensuring stricter supervision of financial transactions in offshore financial centres, and support the US initiative to increase the risk weighting on lending to such centres not meeting international supervision standards.

### **Private Participation in Crisis Prevention and Resolution**

Over borrowing by emerging market governments, banks and firms is logically matched by voluntary over lending by private investors in advanced economies. There is thus a need for more equitable burden sharing when initial expectations are not supported by subsequent events. Increased private burden sharing would also help to reduce moral hazard on the part of lenders.

For that purpose, the international financial community should explore measures to facilitate greater private sector involvement on fair burden sharing principles. Such measures should be used for a quick and orderly execution of debt relief and restructuring, without undermining the debt contracts, which would restrain market access. Protection of debtors and creditors should be carried out on equitable grounds.

In the long-term, the establishment of an international legal mechanism for restructuring sovereign debt contracts similar to the Chapter XI proceedings under the US bankruptcy law may be desirable. Emerging market economies should first strengthen their domestic bankruptcy laws. They should then explore the possibility of establishing mutual recognition agreements with the leading financial centres.

Ex ante measures for debt restructuring will enhance the degree of predictability when a need to restructure international sovereign bonds arises. Sovereign debtors, both G-7 and emerging market countries alike, should encourage the use of 'collective action clauses' in debt contracts. Conditions such as put-options and cross default clauses that can precipitate default during payment difficulties should be cautiously utilized.

When a debtor country has entered 'bona fide' negotiations with a majority of its private creditors, and is following the terms of an agreement with the IMF, the International Monetary Fund should sanction, and the G7 governments support, a temporary suspension of payments if needed in order to allow negotiations to be successfully concluded.

### **Social Protection Mechanisms for Financial Stability**

The international community should recognise that sound social protection systems should be in place in order to both protect vulnerable groups in emerging market countries and maintain political consensus on sound economic policy.

Greater use of fiscal resources by emerging market governments for public provision of social protection should be encouraged by creditors, so long as it is consistent with fiscal prudence.

The international financial institutions should provide more long-term social funding for emerging market countries when the need arises. Provisions should be made for more rapid and less conditional disbursement of funds as safety nets in crises.

### **The Reform of International Financial Institutions**

Reformed International Financial Institutions (IFIs) form an essential part of the new International Financial Architecture: their constitutional structures, developmental mandates and operating principles require revision in the light of the realities of global capital markets in the 21<sup>st</sup> century.

In view of the extremely pro-cyclical nature of private capital flows, there is an urgent need for the International Monetary Fund to stand ready to provide the required liquidity on a timely basis, for which purpose greater resources will be needed.

The policy conditions included in loan agreements with the Fund should be tailored to specific economic conditions of the recipient country in question. The imposition of a single model of monetary stabilisation and structural adjustment should be avoided, particularly in the midst of financial crises. The Fund should strengthen and broaden its understanding of the characteristics of emerging market economies by drawing on expertise from these countries.

The pre-qualification conditions for Contingent Credit Lines should be made more realistic so that they help rather than hinder crisis prevention and resolution. This would increase the likelihood that such facilities would be taken up by emerging market governments.

The 'division of labour' between the Bretton Woods institutions should be clarified. The IMF should focus on short-run stabilisation policy advice and the provision of liquidity; and should avoid pressures to extend its mission to wider matters of institutional change and development strategy.

The World Bank should focus on longer-term development support, particularly the funding of social and economic infrastructure where private capital is not available on reasonable terms. The ability of the World Bank and other multilateral development banks to support long-term private lending should be augmented by a modification of the gearing ratios in their guarantee schemes. The Bank and the Fund must also coordinate more effectively in crisis situations.

Emerging market countries' representation in the share capital and executive boards of the International Financial Institutions (IFIs) should reflect more accurately their respective importance in the world economy. Meanwhile, the IFIs themselves should apply internationally accepted principles of institutional transparency and accountability in order to protect the interests of emerging market countries as 'minority shareholders.'

### **Regional Monetary Arrangements and Financial Co-operation**

Regional economic and financial cooperation arrangements should be strengthened in order to promote regional stability, and contribute to crisis prevention and resolution. This in turn should contribute to the stability of the global economy. Regional arrangements for monetary and financial cooperation should be encouraged and supported by the G7 as complementary to the multilateral IFIs.

A future direction for the coordinated use of reserves by central banks in order to prevent speculative attacks has been illustrated in the currency swap arrangements under the initiative of ASEAN+3 countries. Such arrangements may not be as effective for regions where the level of reserves is limited, but the scope for collective action by monetary authorities in support of regional financial stability is worth further exploration.

