New Financial Architecture as a Global Public Good

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International financial stability and efficiency is a very important global public good, especially significant for poor people in developing countries and emerging economies. This global public good can be decomposed into two parts: a) the avoidance and better management of currency and financial crises, which, as recent experience has shown, are very costly for developing countries and for poor people (indeed, deep and frequent crises in developing countries could undermine achieving the United Nations target to halve poverty by 2015) and b) the provision of sufficient long-term, stable capital flows to different categories of developing countries, including low-income countries. Provision of adequate capital flows is particularly important today, given the collapse of net private flows to lower-income countries, and the sharp drop in net private flows to emerging markets, which turned negative in 2001.

Both industrial and developing countries face the difficult challenge of creating a global financial system that supports—and does not undermine—growth and development in the dramatically changed context of the twenty-first century. That system is characterized by large but extremely volatile and highly concentrated private capital flows, as well as relatively small international public financial institutions. There is no clear blueprint for what such an international financial architecture should look like. However, a clear vision of key elements in this architecture has emerged from international discussions since 1998 and from parallels drawn from the institutional mechanisms developed nationally.

At the international level there is a need to ensure appropriate transparency and regulation of international financial loan and capital markets, to provide sufficient international official liquidity in distress or crisis conditions, to establish mechanisms for standstill and orderly debt work-outs at the international level, and to create appropriate mechanisms for sufficient development finance. Ensuring transparency and appropriate regulation internationally would help prevent crises, which are developmentally, socially, and financially very costly. Providing international official liquidity in times of crisis and establishing mechanisms for orderly debt workouts would help manage crises better, making them less costly, especially to poor people in developing countries. Creating appropriate mechanisms for development finance would help channel public flows to low-income countries, provide countercyclical long-term finance to emerging markets when private flows dry up, and help fund global public goods.

Given the collapse of private flows to developing countries since the Asian crisis and the possibility that private flows may not recover soon, there is particular urgency in providing sufficient official liquidity. This seems to require using existing International Monetary Fund (IMF) facilities to enable quick disbursement of IMF loans, particularly in cases when balance of payments problems, in either the capital or the current account, are caused by factors external to the country. Given insufficient private flows and the sharp slowdown in the world economy, a strong case can be made for issuing Special Drawing Rights (SDRs). Given the deflationary trends in the world economy, issuing these instruments would not generate inflationary pressures. It would, however, help support economic activity in developing countries. A first step would be ratification by the U.S. Congress of the special 21 billion SDRs already authorized by the IMF.

Creating appropriate mechanisms for development finance would require additional official resources, both concessional and nonconcessional. The $50 billion increase in aid proposed in the Zedillo report (United Nations 2001) and supported by the British Chancellor of the Exchequer, Gordon Brown, would provide a sustainable basis for increases in concessional development finance, as well as for other essential purposes.

As our key concern here is global financial stability, we stress the global and regional dimensions of the international financial architecture. Naturally, however, these measures have to be complemented by better policies in the recipient countries. Up to now most action has taken place precisely in these national aspects of recipient countries, with very limited progress on the truly international aspects of the required architecture. The international dimension is crucial, as crises are caused, to an important extent, by failures in private global financial markets, which need to be tackled at the international level.

Progress on International Financial Reform

Frequent currency and banking crises in the second half of the 1990s generated a broad international consensus that fundamental reforms were required in the international financial system. Existing institutions and arrangements were widely seen as inadequate. These crises have continued in the twenty-first century.

It is therefore necessary to evaluate progress achieved toward reforming the international financial system. Some progress has been made, but it is clearly insufficient. IMF lending facilities have been quite usefully expanded and adapted, and the Fund's total resources have been increased. Important institutional innovations have been introduced, such as the creation of the Financial Stability Forum. Another positive development is the creation of the G-20, a group of 20 industrial and developing countries established to discuss international financial reform.

Developing countries have taken a number of important steps to make their countries less vulnerable to crises. These include both more prudent macroeconomic policies and the introduction of a large number of codes and standards.

Unfortunately, progress on international financial reform has been insufficient and asymmetrical. This seems surprising, given that such reform would support higher growth both in developing and industrial countries and that there is broad support for these objectives.

Given this support, why has more progress not been made? An important part of the answer seems to be that while there is broad consensus on the need for reform, there is far less agreement on specific measures needed to build a new financial architecture (see table 1).

Table 1. Support of Specific Changes in the International Financial Architecture by Various Actors

Change	*Financial markets*	*Industrial countries*	*Developing countries*	*International financial institutions*	*Outcome*
Adoption of codes and standards	Vaguely, yes	Yes	Some opposed or reluctant	Yes	Changes occur
Provision of sufficient international liquidity	Yes	Not large	Yes	Broadly, yes	Changes do not occur
Increased development finance	Vaguely, yes	No	Yes	Yes	Changes do not occur
Provision of sufficient and appropriate international regulation	No	Lukewarm	Lukewarm, linked to representation	Unclear	Changes do not occur
Adoption of standstill and orderly debt work-outs	No	Yes, some quite keen	Varies, not too keen	Quite keen	Changes do not occur
Increased participation by developing countries	Indifferent	No	Yes	Unclear	Changes do not occur

Source: Author.

Suggestions for Accelerating and Deepening International Financial Reform

To ensure that measures to accelerate and deepen international financial reform are adopted, developing countries need to develop a consistent strategy for persuading—and bargaining with—industrial counties to act. The United Nations International Conference on Financing for Development in March 2002 in Monterrey, Mexico, if effectively used, could provide a key milestone.

Developing country governments and their supporters should present the need for a new financial architecture as providing one of the key pillars for sustained economic growth, development, and poverty reduction in their countries, within the context of a well-managed global market economy. Such sustained growth in their economies would also contribute to higher global growth, thus benefiting all global actors involved. Higher growth in the South would imply larger and growing markets for industrial country exporters, better and more profitable opportunities for industrial country investors and lenders, and less pressure for low-skilled migration from developing to industrial economies.

Developing countries' markets—including their financial markets—are of great interest to industrial country investors, lenders, and exporters. The extent to which developing countries strengthen and regulate their financial system, as well as liberalize their capital accounts, are of great interest not just to their own companies and people but also to international companies and banks in industrial economies. To break the current logjam and achieve progress, some type of grand bargain could be conceived.

Developing countries could agree to do more to implement initiatives of interest to industrial economies (such as adopting codes and standards of best practices on financial regulation) and to further liberalize their capital accounts if, and only if, industrial countries began reforming the global financial system in ways that would facilitate more and more stable capital flows to developing countries, making costly crises in these countries less likely. Without such a reformed international financial system, they would clearly be less able and less willing to open their capital accounts fully, as the potential risks of doing so could outweigh the benefits. Similarly, developing countries could argue that their implementation of codes and standards of financial regulation (which were determined mainly by regulators in industrial countries) should be explicitly linked to regulation of financial markets in industrial countries and the development of international liquidity mechanisms, with little or no ex post conditionality. These steps would protect individual developing countries from crises, prevent crises from spreading to other countries, and provide sufficient development finance. SDR allocations or quota increases could prove crucial in this regard, with these instruments playing a key role in enhancing the stability and efficiency of the international financial system.

Developing countries that adopt good macroeconomic policies and significantly improve their financial regulation policies (as certified, for example, in their annual Article IV IMF consultations) could have practically automatic access to sufficient IMF lending if hit by a crisis caused by unexpected changes in perceptions of international lenders and investors or large terms of trade shocks. Low-income countries that adopted good macroeconomic policies, improved financial regulation, and took other measures would have sufficient access not just to international liquidity but also to development finance.

Such a bargain would provide incentives for industrial countries to make necessary international changes, and to developing countries to make national changes. Collective action problems could be overcome if genuine progress was made simultaneously by industrial and developing countries. Most important, the result would be of great value, not just to developing countries but also to industrial countries. Provision of the global public good of international financial stability would be enhanced, and the international financial system could contribute far more to development and poverty eradication.

Reference

United Nations. 2001. *Report of the High-level Panel on Financing for Development*. Document A/55/1000. Online: http://www.un.org/esa/ffd/a55-1000.pdf