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The Future of the International Financial Architecture

By Peter G. Peterson and Carla A. Hills

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Summary: The global financial turmoil that began in Thailand in 1997 has forced the international community to reevaluate the institutions, structures, and policies aimed at crisis prevention and resolution. In September 1998 President Clinton suggested that a distinguished private-sector group assess the need for reform of the international financial architecture. With this concern in mind, the Council on Foreign Relations sponsored the Independent Task Force on the Future of the International Financial Architecture, cochaired by 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 U.S. Trade Representative during the Bush administration.

THE FUTURE OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

A Council on Foreign Relations Task Force

The global financial turmoil that began in Thailand in 1997 has forced the international community to reevaluate the institutions, structures, and policies aimed at crisis prevention and resolution. In September 1998 President Clinton suggested that a distinguished private-sector group assess the need for reform of the international financial architecture. With this concern in mind, the Council on Foreign Relations sponsored the Independent Task Force on the Future of the International Financial Architecture, cochaired by 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 U.S. Trade Representative during the Bush administration.

Morris Goldstein, former deputy director of research at the International Monetary Fund and now a senior fellow at the Institute for International Economics, served as project director and author of the report. Task force members are listed on page 171.

The following is an edited executive summary of the task force report. A full-length version of the report and dissents can be found on the Council on Foreign Relations Web site, at www.cfr.org.

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 nosedived, 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 in September 1998, characterized the 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 was at least a tenth -- and sometimes much more -- of the stricken country's annual national income. The U.S. savings-and-loan crisis of the late 1980s cost taxpayers about 2 to 3 percent of U.S. 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 peso devaluation 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.

Banking, currency, and debt crises cannot be eliminated 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 -- is also very much in the national interest. The U.S. 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 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 U.S. exports go to developing countries. American 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 U.S. savings is invested abroad. Borrowing costs, including the monthly payments that U.S. households make for their home mortgages, are lower because of American participation in international capital markets.

But why worry, some might ask. After all, the U.S. economy has continued to perform impressively throughout the latest crisis period. But to conclude that fragility in the international financial system is somebody else's problem would be dangerously complacent. In the recent emerging-market turmoil, U.S. 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 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 America might not be so well positioned to weather the storm.

One 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 Americans that international capital markets -- despite their important contribution to the U.S. standard of living -- can at times be risky places. The more successful Americans are in reducing the frequency and severity of financial crises, including in emerging economies, the better are the chances of safeguarding America's jobs, savings, and national security as well as of promoting global prosperity.

THE TASK FORCE'S APPROACH

If the international community is to improve crisis prevention and management in the developing world, it must put the primary responsibility back where it belongs: on emerging economies themselves and on their private creditors who 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 this analysis. The new international financial architecture should

1. Encourage emerging economies to intensify their crisis prevention efforts.

2. Permit savings to flow to the countries and the 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 International Monetary Fund (IMF) and the World Bank on areas they are best equipped to address.

RECOMMENDATIONS

Consistent with these principles, the task force offers seven key recommendations.

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: discouraging liquid liabilities of the public and private sectors from getting way ahead of their liquid assets and avoiding 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. Such a system would comply 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.

Many of these elements of good housekeeping were not in order in the prelude 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 these countries' vulnerability. In Asia, 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 that were lower abroad than at home, exchange rates that had been relatively stable against the U.S. dollar, and 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 U.S. 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 to defend currencies pegged to the dollar. Political instabilities and uncertainties added to the problem. And when currencies fell sharply, their depreciation 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" that 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. 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 considerably benefited 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 also helped foster the transfer of best-practice production processes.

But experience indicates that 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 U.S. Treasury bonds. For example, this interest rate spread was 1,200 basis points (12 percentage points) in January 1991; 400 basis points in January 1994; 1,600 basis points in January 1995; 400 basis points in mid-1997 (just before the

Asian crisis began); 1,400 basis points in the fall of 1998 (just after Russia's debt default); and 1,100 basis points in July 1999.

Although 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 suggests that "boom and bust" cycles in such flows create serious problems. When capital inflows are very large and outstrip the domestic capacity to supervise the financial sector and build a credit culture, they sow the seeds of subsequent banking crises. In several Asian countries, the recent crisis was preceded by bouts of premature and poorly supervised financial liberalization. In Thailand, for example, the Bangkok International Banking Facility wound up unintentionally serving as a conduit for local firms to vastly expand their loans from foreign banks, with unhappy results.

Turning to the "bust" side of the cycle, a sudden stop or reversal in private capital flows is often the event that ushers in a crisis. This situation can turn liquidity problems into solvency problems, induce large cuts in spending that bring on recession, and spread crises considerably beyond their origin. For five Asian emerging economies heavily affected by the recent crisis, net private capital flows went from an inflow of $65 billion in 1996 to an outflow of $43 billion in 1998; Japanese banks alone withdrew $21 billion from these five countries in 1997 (versus a $50 billion inflow in 1996).

The challenge, therefore, is to find ways to moderate the boom-bust cycle in private capital flows and tilt the composition of such flows toward longer-term, less crisis-prone components (such as foreign direct investment) while preserving most of the benefits associated with greater market access.

Short-term capital flows carry a high risk because their short maturity makes it easier for investors to run at the first hint of trouble. Whereas net flows of foreign direct investment to emerging economies recorded only a slight decline during the recent Asian crisis, the fall in portfolio flows and bank loans was much more pronounced. Chile has addressed this problem by, in effect, taxing capital inflows if they are withdrawn after only a short time. This seems to have tilted the composition of its inflows toward the less risky, longer-term components. Admittedly, the effectiveness of such measures does tend to erode over time, and one side effect is that some desirable short-term flows -- such as credits to support trade -- can also be deterred. Nevertheless, if the alternative is a boom-bust cycle followed by a costly financial crisis, the choice seems clear.

The IMF should therefore advise those emerging economies with fragile domestic financial sectors to impose Chilean-type taxes on short-term inflows until their ability to intermediate such flows is stronger. The measures should be transparent and designed not to impede the entry of foreign financial institutions, which can make a valuable contribution to strengthening domestic financial systems.

Other measures can moderate the boom-bust cycle. For one, emerging economies should not impose controls or taxes on long-term inflows. One reason why South Korea relied so heavily on short-term inflows was that it had controls that kept long-term flows out. For another, in revising the international agreement that specifies how much capital internationally active banks need to hold against various kinds of assets (the Basle Capital Accord), regulators should avoid weighting schemes, which provide incentives for short-maturity flows.

Hedge funds, which often finance very-short-term investment decisions with huge sums of borrowed money, have gained a certain notoriety in financial crisis episodes. But a review of these episodes, including the recent events in Asia, suggests that hedge funds are not the villains they are often made out to be. At the same time, given the threat highlighted by the near-collapse of LTCM last year, the official community is right to step up the "indirect" regulation of hedge funds by tightening risk-management guidelines for the banks and security houses that lend to them. Financial regulators should give this approach a fair trial. But if it does not produce results, they should consider going further by imposing a higher regulatory capital charge (risk weight) for bank loans that go to offshore financial centers (where many hedge funds are located) that do not meet international financial standards.

RECOMMENDATION 3. The Private Sector: Promote Fair Burden-Sharing and Market Discipline

If a country faces an unsustainable burden of debt repayments, inevitably they will have to be rescheduled. It benefits neither debtors nor creditors if this takes a long time. But there are formidable institutional barriers to a quick resolution. There is no international bankruptcy code, and in many developing countries national bankruptcy laws either do not exist or function poorly. There are mechanisms through which debts payable to governments can be rescheduled cooperatively, but there is no equivalent for debts to the private sector.

If debt difficulties are resolved with large official bailouts -- be it by national authorities or by the international financial institutions -- then there will be problems of a different but equally serious nature. If market participants come to routinely expect such bailouts, then private creditors will have little incentive to monitor the financial condition of borrowers. Too many resources will be channeled to the borrowers and lending categories viewed as implicitly "insured," and taxpayers and legislatures in creditor countries may withdraw their support for such rescues because they are being asked to bear the consequences of poor lending and borrowing decisions by other parties. One reason it was so difficult to secure approval from Congress for an increase in the IMF's financing last year was the perception that Wall Street -- and in particular large banks -- benefited much more from official rescue packages than did Main Street.

These problems generally fall under the heading of "moral hazard." As with other types of insurance, the appropriate response to moral hazard should be to limit the size of insurance payments and charge risky policyholders more for the insurance -- rather than providing no insurance at all.

Problems with debt rescheduling and moral hazard have become more pressing in recent years. The share of bonds in emerging-market financing has increased sharply while that for bank loans has declined. Bonds are "rescheduling unfriendly" compared to bank loans. For government bonds, one solution would be to include clauses in contracts to make it harder and less profitable for rogue creditors to impede a rescheduling; such "collective-action clauses" already are included in syndicated bank loans. Successive reports by industrial-country governments have in fact recommended such collective-action clauses. But it is unrealistic to expect emerging-market countries to take this step on their own if highly creditworthy rich countries refuse to join in or to make it worthwhile to do so.

On the moral hazard front, significant difficulties exist at both the national and international levels. At the national level, the past several decades have witnessed rapid growth in the banking and financial sectors of emerging economies. Yet the vast majority of these countries do not have in place a good system of deposit insurance for their banks. Such a system should put the burden of rescuing failed banks on shareholders and on large, uninsured creditors rather than on small depositors and taxpayers or international institutions; it should place stringent accountability conditions on senior economic officials when they decide to rescue a bank because it is "too large to fail"; and it should give bank supervisors protection against strong political pressures to delay taking corrective actions. This is the kind of deposit insurance reform that was introduced in the United States after the 1980s savings-and-loan crisis. Without such reform, those most responsible for causing banking crises often get off the hook while others pay the tab.

At the international level, it is true that equity investors and bondholders experienced large losses in the Asian crisis, and banks took sizable hits from the Russian crisis. But too often, large rescue packages allow private creditors -- particularly large commercial banks -- to escape from bad lending decisions at relatively little cost. The $50 billion Mexican rescue package of February 1995 allowed holders of certain Mexican government securities (tesobonos) to get out whole. The international community committed about $190 billion in official rescue packages for Thailand, Indonesia, South Korea, Russia, and Brazil, one-third of which has so far been disbursed. The Miyazawa plan has committed $30 billion more to Asian rescue packages. The Thai, South Korean, and Indonesian authorities issued broad guarantee announcements for bank depositors and creditors shortly after the outbreak of their crises, and the bulk of the short-term debt rescheduling of South Korean banks was done with a government guarantee.

One need look no further than private capital flows to Russia and Ukraine in the run-up to the crisis -- widely known on Wall Street as "the moral hazard play" -- to see what happens when moral hazard effects become large. Despite serious underlying weaknesses in the economic fundamentals, investors were prepared to purchase large amounts of high-yielding government securities, presumably under the expectation that should conditions worsen, geopolitical and security concerns would prompt G-7 governments and the IMF to bail them out.

To be sure, when official rescue packages are evaluated, a balance must be struck between limiting systemic risk and encouraging market discipline. By providing emergency assistance to an illiquid but not insolvent borrower and thereby preventing a costly default and its possible spillover to other borrowers, an official crisis lender can limit the risk to the financial system as a whole. On the other hand, if such emergency assistance is too readily available, too large, and too cheap, lenders will not learn the lessons of their mistakes and market discipline will suffer. But in recent years that balance has tilted too far away from market discipline. Unless balance is restored, we will not be successful either in deterring future crises or in garnering popular support for official rescue packages.

To bring more order and timeliness to private debt rescheduling, all countries, including the G-7, should include collective-action clauses in their government bond contracts. The G-7 should match its words with actions by also requiring that all government bonds issued and traded in their markets include such clauses.

The IMF should encourage emerging economies to maintain comprehensive registers of their creditors. Creditors in turn should be encouraged to form standing committees that could help coordinate future debt rescheduling. To reduce moral hazard at the national level, the IMF should advise emerging economies to enact sensible deposit insurance reform in their banking systems. At the international level, the IMF should provide emergency assistance only when there is a good prospect of resolving the applicant country's underlying balance of payments and debt problems. In the extreme cases when this requires rescheduling of private debt, the fund should make "good faith" discussions on such rescheduling a condition for its own assistance and should be prepared to support a temporary halt in debt repayments. No category of private debt (including bonds) should be exempt from such rescheduling, and it should be done in a way that does not discriminate between domestic and foreign creditors.

RECOMMENDATION 4. Just Say No to Pegged Exchange Rates

One of the most important steps an emerging economy can take to reduce the risk of a crisis is to get its exchange-rate policy right. The events of the past two years have highlighted the risks of trying to defend a currency regime based on a publicly announced exchange-rate target, and especially so for "adjustable peg" regimes (in which an emerging economy pegs its currency to that of a larger economy, usually the U.S. dollar, with an option to adjust the peg when underlying conditions change). Thailand, Malaysia, the Philippines, Indonesia, Russia, and Brazil have all been forced to abandon announced exchange-rate targets during the recent emerging-markets crisis. Among larger emerging economies with open capital markets, the list of those that have been able to maintain a fixed exchange rate for five years or more is now very short: Argentina and Hong Kong.

Pegged exchange rates have their attractions. They can be an effective instrument for reducing high inflation. But the potential risks of pegged exchange rates, particularly their vulnerability to crises, outweigh the benefits. Pegged rates become problematic when they become highly overvalued. This can happen either because the country's inflation rate (even if it is much reduced from earlier periods) remains higher than that of its trading partners, or because the currency to which it is pegged is rising and dragging it up against other currencies. In either case, a highly overvalued exchange rate translates into poor competitiveness, making the currency a target for speculators. But there is no easy way to exit gracefully from a pegged exchange rate. When the overvaluation is small, there is apt to be little political support for upsetting the apple cart with a change in the pegged rate, and by the time the overvaluation has become large and obvious, it is often too late to avoid a crisis.

Once a country runs low on international reserves, the brunt of the defense of a pegged exchange rate falls on high domestic interest rates to make assets denominated in its currency more attractive. But high interest rates slow economic growth and raise unemployment, make things worse for fragile banking systems, exacerbate the fiscal problems of governments with large fiscal deficits and lots of floating-rate debt, and add to the cash flow problems of highly leveraged corporations. Speculators, many of whom can finance very large positions in the foreign-exchange market, know that there is a limit to how long countries can keep interest rates sky-high. In most of these battles, David and his sling (that is, his fixed exchange rate and high interest rates) have been crushed by Goliath (the international capital market), and it is not easy to see why this asymmetry would disappear over the foreseeable future.

In some recent crises (for example, Brazil and Russia in 1998-99, Mexico in 1994-95, and some member countries of the European Exchange Rate Mechanism in 1992-93), exchange-rate overvaluations were sizable. In the case of the Asian crisis countries, their currencies appeared to be only modestly overvalued in mid-1997, but large current account deficits, sharply falling export growth, weak banking systems, and highly leveraged corporations made them vulnerable. In addition, because their exchange rates had been relatively stable for a long time, banks and corporations did not protect themselves against currency risk. Hence the consequences of large foreign-currency exposure were that much more painful when large devaluations finally occurred.

None of this analysis intends to claim that other currency regimes are not without their own problems. Rather, it simply argues that an adjustable-peg regime seems particularly crisis prone for emerging economies.

Despite the risks, history suggests that emerging economies will be tempted to defend an overvalued pegged exchange rate if IMF and G-7 funds are available to finance that defense. The IMF and the G-7 therefore should go beyond advising emerging economies not to adopt an adjustable-peg regime. If asked to support an unsustainable peg, the fund and the G-7 should "just say no." The mainline currency recommendation for emerging economies should instead be one of "managed floating," with the use of currency boards and single currencies reserved for particular situations.

RECOMMENDATION 5. IMF Crisis Lending: Less Will Do More

The IMF was created to help countries tackle balance-of-payments problems without resorting to draconian austerity measures, beggar-thy-neighbor exchange-rate policies, and trade barriers. This remains an extremely valuable goal. Indeed, as costly as the recent emerging-market crises have been, the world would have seen deeper recessions, more competitive devaluations, more protectionism, and far more human suffering had there been no financial support from the IMF and from other official creditors.

But this does not mean that bigger is better. Rescue packages for country crises should be large enough to reduce the recessionary impact of the crisis, finance some smoothing operations in currency markets, contribute modestly to the cost of bank restructuring, and provide a social safety net that provides some protection against the hardships of the crisis for the most vulnerable groups in the economy. In the overwhelming majority of cases, the fund's normal lending limits (100 percent of a country's quota or IMF subscription annually and 300 percent of quota cumulatively) ought to be sufficient. Rescue packages should not be so large as to provide cover for holders of short-term external debt to escape the consequences of poor lending decisions, lest they generate the kind of moral hazard problems emphasized above. IMF loans to Mexico (1995), Thailand and Indonesia (1997), and Brazil (1999) were in the neighborhood of 500-700 percent of IMF quotas, and the loan to South Korea (1997) was 1,900 percent of its quota.

The task force is not persuaded that smaller rescue packages would necessarily make it more difficult for emerging economies to regain the confidence of investors. Experience suggests that this owes more to the speed and determination with which underlying economic problems are addressed. The expectation of smaller rescue packages may well reduce somewhat the flow of private external finance to emerging economies and increase somewhat its cost. But since interest-rate spreads on emerging-market borrowing have been too low and the flow of capital to them too high during much of the 1990s, some moderate movement in the other direction would be no bad thing, especially for those emerging economies with relatively high domestic savings rates.

But what about rare situations of widespread cross-border "contagion" of financial crises, where failure to intervene would threaten the performance of the world economy and where private capital markets are not distinguishing well between creditworthy and less-creditworthy borrowers?

To counter such systemic threats effectively, the international community needs quick access to an adequately and securely funded international backup facility that can assist the victims of contagion. This would supplement the existing credit lines (the New and General Agreements to Borrow, or nab/gab) that the IMF already has available from a set of creditor countries. In April 1999 the IMF established a new lending window, the Contingency Credit Line (CCL), to offer assistance to well-behaved countries that feel threatened by contagion. But the CCL contains no new money and its operational guidelines seem unnecessarily complex.

The task force proposes that the IMF return to normal lending limits (100-300 percent of quota) for country crises -- that is, for crises that do not threaten the performance of the world economy. In the unusual case of a systemic crisis, the IMF should turn to its systemic backup facilities -- either the existing nab/gab or a newly created "contagion facility" that would replace the existing Supplemental Reserve Facility (SRF) and the CCL. Activation of the systemic facilities would require a decision by a large majority of creditors. The nab/gab would be used when the country's problems are largely of their own making and an IMF program is needed to correct those problems. The contagion facility would be used for victims of contagion. Loans from the contagion facility would be agreed on expeditiously, would be disbursed quickly, would be free of policy conditions, and would be priced more expensively than normal loans from the fund. This contagion facility would be funded by pooling a one-off allocation of Special Drawing Rights, the IMF's artificial currency. The U.S. contribution to that contagion facility would be made after extensive consultation with Congress.

RECOMMENDATION 6. Refocus the IMF and the World Bank: Back to Basics

The emerging-market crises have shaken public confidence in the Bretton Woods institutions. But their roles are crucial -- the IMF as a key crisis lender and manager and also increasingly as a monitor of compliance with international financial standards, and the World Bank as a promoter of poverty reduction and sustainable economic development.

Calls for their abolition are misplaced. There is a moral hazard problem associated with large IMF-led financial rescues, but this can be reduced significantly by altering the IMF's lending policies along the lines sketched above. Although hindsight reveals that the fund's monetary and fiscal policy recommendations to the Asian crisis countries were by no means flawless, these are best regarded as judgment calls in a difficult situation that had no easy solutions. For example, although an earlier move to lower interest rates would have helped counter the recession by reducing debt burdens and cash-flow vulnerabilities, it carried the risk of accelerating currency depreciation when banks and corporations had large, unhedged foreign-currency liabilities and confidence was already very weak.

To reject the abolition of these institutions is not to deny that there is a need for reform of the Bretton Woods twins. Both the IMF and the World Bank have tried to do too much in recent years, and they have lost sight of their respective strengths. They both need to return to basics. The task force argues that the fund should normally lend less and concentrate more on encouraging crisis prevention. It should also focus on a leaner agenda of monetary, fiscal, and exchange-rate policies, and of banking and financial-sector surveillance and reform. It should leave more detailed structural reforms to the World Bank and other international organizations with the requisite expertise in those areas.

The World Bank, in turn, should focus on the longer-term structural and social aspects of economic development. It should not be involved in crisis lending or crisis management, and it should refrain from publicly second-guessing the fund's macroeconomic policy advice. One area where the bank can and should do more is in the design of social safety nets. When crises strike, the burden of economic adjustment usually falls hardest on those least able to cope. The recent crises in Asia have provided fresh affirmation of this danger, and the need to protect the poorest and most vulnerable would be even more pressing if official rescue packages became smaller in the future. Although this report concentrates on the financial architecture and on the role of the IMF, one should remember that financial stability is not an end in itself but rather a means to broadly shared global prosperity -- and that it is a fantasy to believe that financial stability can be maintained without attention to the social aspects of development.

RECOMMENDATION 7. Generate Political Support for Reforms

Many of the cracks in the international financial system reflect weaknesses in national policies. Remedying these defects -- be it by strengthening financial systems in emerging economies or by altering some institutional practices in industrial economies -- might be unpopular and will on occasion demand that powerful vested interests be confronted. In addition, experience suggests that reform programs are most successful when the countries most affected participate directly in the design of those measures. If the emerging economies are not full partners in the reform exercise, it will not work. Intensive discussions on strengthening the financial architecture have been under way for about five years, since the Mexican peso crisis of late 1994. With prospects for recovery from the global crisis brightening, there is a danger that fatigue and complacency could combine to stall the push for reform -- and this before most of the measures set out in this report could be implemented.

For all these reasons, governments will have to demonstrate considerable political will to carry the reform agenda through. To help foster the necessary political commitment, the international community should directly involve the nations whose behavior should change. The IMF's Interim Committee, the Financial Stability Forum, and the presidents of the regional development banks therefore should convene a special global meeting of finance ministers to establish priorities on architectural reform measures and agree on a specific timetable for specific corrective steps.

CONCLUSION

Many of the themes emphasized in this report have also been part of the official sector's plans and suggestions for the future architecture. Nevertheless, our approach differs from theirs in several important respects.

The task force believes in stronger measures to reduce moral hazard and encourage market discipline, and in particular to induce private creditors to accept their fair share of the burden of crisis resolution.

The task force believes that the IMF should return to more modest rescue packages for country crises and that large rescue packages should occur only in systemic cases with the agreement of a large majority of creditor countries.

The task force believes that the IMF and the G-7 should take a harder line on limiting official support for adjustable-peg currency regimes, and that the IMF should be more active in identifying publicly which countries are meeting international financial standards.

The task force is more forthright in advocating tax measures to shift the composition of capital inflows in emerging economies to longer-term, less crisis-prone investments.

The task force believes that the major industrial countries should be more willing to take the lead in enacting institutional reforms in capital markets.

The task force prefers a simpler and better-funded backup facility to deal with systemic episodes of contagion of financial crisis.

The task force proposes a stricter demarcation of responsibilities and leaner agendas for the IMF and the World Bank.

The task force suggests a vehicle for garnering political support and establishing a timetable for reform of the international financial architecture.

The recommendations outlined in the report are those that were able to command majority support within the task force. Many other proposals, however, were actively debated. A large group of task force members (Paul Allaire, C. Fred Bergsten, George David, Maurice Greenberg, Lee Hamilton, John Heimann, Ray Marshall, James Schlesinger, George Soros, Ezra Vogel, and Paul Volcker) felt that there could be no serious reform of the architecture without fundamental reform of g-3 currency arrangements. They argued that the impact of the global economy on emerging economies is driven significantly by swings among the g-3 currencies, and that in recent years these swings have been enormous, volatile, and frequently unrelated to underlying economic fundamentals. They favored a system of rather broad target zones or reference ranges for the dollar, the euro, and the yen. Some other task force members favored stronger regulation over highly leveraged institutions (Bergsten, Greenberg, Carla Hills, Laura D'Andrea Tyson); a global summit on architectural reform to be held by heads of state and governments (Bergsten, Hills, Peter Peterson, Tyson); greater incentives for crisis prevention and greater use of early warning indicators of financial crises (Bergsten, David); a more structural approach to reform of the international financial architecture (Tyson, Volcker); a link between core labor standards and international financial standards (Marshall); a different approach to collective-action clauses in bond contracts, taxes on capital inflows, and private-sector burden-sharing (William Rhodes); or new measures to encourage sound long-term lending to emerging economies (Soros).

The task force also discussed more radical alternatives. These included comprehensive controls on capital flows, the adoption of single currencies, more far-reaching reforms of the IMF (ranging from its abolition to the creation of a much larger and more powerful fund), and the establishment of new, supranational regulatory institutions. In the end, the more radical proposals seemed either undesirable or impractical. The task force therefore opted instead for what would be characterized as "moderate plus" proposals: proposals that, taken together, would make a significant difference to crisis prevention and management but still have a reasonable chance of acceptance.

Task Force Members

Paul A. Allaire, Chairman and Chief Executive Officer, Xerox Corporation; C. Fred Bergsten, Director, Institute for International Economics; Kenneth W. Dam, Max Pam Professor of American and Foreign Law, University of Chicago; George David, Chairman and Chief Executive Officer, United Technologies Corporation; Jorge I. Dom'nguez, Director, Weatherhead Center for International Affairs, and Clarence Dillon Professor of International Affairs, Harvard University; Kenneth M. Duberstein, Chairman and Chief Executive Officer, the Duberstein Group; Barry Eichengreen, John L. Simpson Professor of Economics and Political Science, University of California, Berkeley; Martin Feldstein, George F. Baker Professor of Economics, Harvard University, and President, National Bureau of Economic Research; Morris Goldstein, Dennis Weatherstone Senior Fellow in International Finance, Institute for International Economics; Maurice R. Greenberg, Chairman and Chief Executive Officer, American International Group, Inc., and Vice Chairman, Council on Foreign Relations; Lee H. Hamilton, Director, Woodrow Wilson International Center for Scholars; John G. Heimann, Chairman, Financial Stability Institute, Bank for International Settlements; Carla A. Hills, Chairman and Chief Executive Officer, Hills & Company; Peter B. Kenen, Walker Professor of Economics and International Finance, Princeton University; Paul R. Krugman, Ford International Professor of Economics, Massachusetts Institute of Technology; Nicholas R. Lardy, Senior Fellow in Foreign Policy Studies, Brookings Institution, and Frederick Frank Adjunct Professor of International Trade and Finance, Yale University School of Management; David A. Lipton, Senior Associate, Global Policy Program, Carnegie Endowment for International Peace; Ray Marshall, Audre and Bernard Rapoport Centennial Chair in Economics and Public Affairs, University of Texas at Austin; Norman J. Ornstein, Resident Scholar, American Enterprise Institute for Public Policy Research, and election analyst, CBS News; Peter G. Peterson, Chairman, Blackstone Group, Chairman, Council on Foreign Relations, Vice Chairman, Federal Reserve Bank of New York, founding Chairman, Institute for International Economics, and founding President, the Concord Coalition; William R. Rhodes, Vice Chairman, Citigroup, and Vice Chairman, Citicorp and Citibank; Stephen S. Roach, Managing Director, Morgan Stanley Dean Witter & Co., and Chief Economist and Director, Global Economic Analysis; Henry B. Schacht, Director and Senior Adviser, Lucent Technologies; James R. Schlesinger, Senior Adviser, Lehman Brothers, and Counselor, Center for Strategic and International Studies; George Soros, Chairman, Soros Fund Management lcc; Laura D'Andrea Tyson, BankAmerica Dean, Walter A. Haas School of Business, University of California, Berkeley; Ezra F. Vogel, Henry Ford II Professor of the Social Sciences, Director, Fairbank Center for East Asian Research, and Director of the Asia Center, Harvard University; Paul A. Volcker, Henry Kaufman Visiting Professor, New York University's Stern School of Business; Vin Weber, Partner, Clark & Weinstock.

Co-chairs: Peter Peterson and Carla Hills

Project Director: Morris Goldstein
