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Toward a New Financial Architecture for a Globalized World

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The G-7/G8 Summit will be held in Birmingham next week. High on the Summit agenda will be the issue of how to renovate the architecture of the international financial system in the face of the tremendous changes under way in the global economy. The Asian crisis has been so unexpected in many of its aspects, so broad, so cruel in its human consequences that—even before the crisis has run its full course—the leaders of the world want to embark on the design of a new architecture. This is certainly the right thing to do, and the venue of this meeting could hardly be more fitting. Like many other cities in advanced countries, Birmingham has experienced the forces of change in the global economy first hand—from the loss of traditional industries to the challenge of finding new employment opportunities. Moreover, two centuries ago, this city was at the heart of the Industrial Revolution, an era that, like our own, was a time of extremely rapid change. At that time, intellectuals of all schools of thought used to meet frequently in Birmingham—every full moon, I understand—and bring their reflections to bear on the challenges of their new world. This was the so-called *Lunar Society*, which included such personalities as Matthew Boulton, James Watt, Erasmus Darwin (grandfather of Charles), and William Small—a friend of Benjamin Franklin and Thomas Jefferson, all with wide-ranging interests, all sharing a sense of optimism and responsibility for building a better world. Imagine what a blessing it would be if the G-7/G-8—our new Birmingham group—were to be inspired by such an example when dealing with their pressing agenda!

As a modest preface to their work, I would like to share with you my personal views on the need for change the Asian crisis reveals, the building blocks available for a new architecture, and the work already under way at the IMF and, in the best traditions of Chatham House, to fly a few kites and suggest some further steps for the longer term.

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Change is needed

As in the days of the Industrial Revolution, we are now at a defining moment of human history. The question before us is straightforward: how to utilize the full potential of globalization to improve the living standards of all—particularly the poorest—while containing the risks it entails, such as those we have seen materialize so brutally in Asia, and those at least equally pernicious, even if less spectacular, of the continuous marginalization of the poorest countries. What kind of new architecture of the global system could achieve this? The response must be deduced from a proper analysis of the most recent crises.

Contrary to what we saw during the debt crisis of the 1980s, the problems in Asia were not almost exclusively macroeconomic in nature; even if these countries suffered, all of them, from some deficiencies in this respect, by and large they had long track records of successful economic management. Rather, in a context dramatically changed by a major realignment between the dollar and the yen, and important differences in short-term yields, three other factors helped trigger the crisis:

- the weakness of their public and private banking and financial structures;
- an unsustainable accumulation of short-term financing—particularly of interbank lending, which Alan Greenspan refers to as the Achilles' heel of the international financial system—which made countries particularly vulnerable to a sudden shift in market sentiment.
- and, last but not least, deep-seated problems of governance, corruption, and what U.S. commentators call "crony capitalism."

Together with the macroeconomic problems, these three major factors had to be addressed for our response to the crisis to be pertinent. If you examine our programs with Thailand, Korea, and Indonesia, you will see that we have tried to deal with these factors, and they will have to be taken into consideration in the future in whatever efforts are undertaken to avoid the recurrence of crises. But even that will not suffice. In view of the enormous human and economic cost of the Asian crisis, no wonder we hear many radical suggestions as to how to avoid such losses in the future. There are calls for us to do a better job of predicting and preventing crises, addressing their social impact more effectively, stopping speculators and properly regulating this "casino economy," seeing to it that investors bear the full costs of their mistakes, stabilizing the international monetary system, providing for more political accountability of our institution, etc., etc.

We cannot deny the basic justification of these—at times vociferous—calls for change. No doubt there are at least some elements of validity in each of them. Taken together they tell us that, at this stage, world public opinion expects its leaders to design and build a new, common house with an audaciously modern architecture, and not limit themselves to some plumbing and interior decorating of the old mansion.

But, as responsible architects, let us start by recognizing the building blocks at hand. Indeed, they are substantial.

Seven building blocks

The first of these building blocks is the tremendous potential for growth and prosperity globalization provides countries fully integrating into the global economy. Formidable sources of dynamism are there, engendered by new information technologies and unifying financial markets. The question, then, is how to discipline and channel these forces so that growth will be sustainable and more broadly shared and the fundamental desire for greater equity will be more fully satisfied.

The second building block is integration. By integrating themselves into the mainstream of the globalizing world economy, the poorest countries will avail themselves of a most powerful instrument of acceleration of development, while, if they preferred to do it alone, they would expose themselves to the risks of marginalization, abandoning several generations to economic stagnation and poverty.

The third building block is the universal consensus on the importance of an increasingly open and liberal system of capital flows in order for globalization to deliver on its promises.

The fourth building block is what we could call the "golden rule" of transparency, now truly seen as the key for modern management, economic success, and rational behavior of global markets.

The fifth is good governance, which is equally essential for strong economies and properly functioning democracies. No doubt, competing for excellence in governance is the modern face of statesmanlike responsibility.

The sixth building block could be a set of standards and codes of best practices; this could require a few words of elaboration. More and more we observe an emerging recognition that the global markets still suffer from the kind of anarchy that afflicted our domestic financial markets here in Europe during the nineteenth and the beginning of the twentieth centuries—that is, until various scandals and crises led to the creation of such institutions and rules as securities and exchange commissions, banking supervision, accounting standards, disclosure and prudential rules, and so forth. Our challenge today is to disseminate these good practices in emerging markets and to establish similar checks and balances in global markets. This could appear an impossible task, as many will pretend that the absence of rules or regulations of any kind has been at the very origin of the developments of these markets. The world community is now coming to a different view, and looks forward for the definition of international standards and codes of good practices, which would be progressively disseminated by the IMF through its surveillance, and could help limit the excesses of an international "casino economy."

Last, but not least, the seventh building block is the option for the multilateral approach to handle problems which are now more and more global in nature. And the key instruments of such an approach will have to be the Bretton Woods institutions themselves. Let me be immodest for a moment. The experience they have accumulated, the quality of their staff, their demonstrated ability to address new economic challenges promptly and efficiently make them a major asset of the world community and a central pillar of a new architecture, provided they continue adapting themselves, reforming themselves, to this new world. And suggestions for self-reform are in abundant supply.

These seven building blocks have been neglected or unevenly utilized for too long. Assembled in the right way, they could offer a rock-solid foundation for a new financial system. Assembling them, nevertheless, will be hard work, each of them implying that vested interests or perverse practices be challenged. Thus, notwithstanding our sense of urgency, we are heading here for an evolutionary change: Athena in her helmet will not spring full-grown from the head of Zeus! And, as with all transitions from one era to another, we can expect risks and uncertainties to persist for some years to come. This makes it all the more urgent to get to work on this new architecture right away.

Initial steps for a new architecture

In fact, a number of significant steps are already under way. At its April meeting, our governing body, the Interim Committee (of Ministers and Central Bank Governors of IMF member countries), set the broad agenda for the IMF's own work—and its work with others—for the near future. Five areas have been given priority by member governments:

- The central role to be played by the IMF in crisis prevention through its surveillance and its role in encouraging members to strengthen their macroeconomic policies and financial sectors.[1]

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[1]Of course, it is clear that for IMF surveillance to be effective, member countries must provide timely, accurate, and comprehensive data to the Fund. The Interim Committee underscored members' obligation in this regard and suggested delaying the Fund's reviews of member economies when deficiencies in disclosing relevant information to the IMF seriously impede our surveillance. Indeed, the G-7 countries have the opportunity this week to establish leadership by pledging to convey to the IMF and to publish comprehensive and timely data on (continued...)

The Interim Committee suggests that the Fund intensify its work in surveillance of financial sector issues and capital flows, and focus on the risks posed by potentially abrupt reversals of capital flows, especially those of a short-term nature. The Fund is also asked to examine ways to strengthen the monitoring of capital flows, a major and difficult undertaking indeed!

- Drawing on the lessons from the Asian crisis, and the frustration that confidential warnings from the Fund were not always heeded, the Fund has been asked to develop a "tiered response," whereby countries that are believed to be seriously off course in their policies are given increasingly strong warnings. Addressing an audience in this country, where football is a way of life, or in my own country in advance of the World Cup, I do not need to emphasize how important it is to know exactly when the referee has shown a yellow card and how many yellow cards are permitted! We also have the red card in our Articles of Agreement, but using this card could precipitate the crisis we seek to avoid. So we prefer to use the yellow card.

- The Interim Committee also called upon the IMF to help members strengthen their domestic financial systems by encouraging them to develop supervisory and regulatory frameworks that are consistent with internationally accepted best practices, as well as strengthened standards for bank and non-bank institutions. Here you will recognize, of course, the "standards and good practices" building block. Work in this area is already in progress in various fora. A notable example is the Basle Committee's Core Principles for strengthening banking regulation and supervision, which the IMF is now helping to disseminate to member countries. We will now work with other relevant institutions that could be responsible for developing similar standards in areas such as accounting, auditing, disclosure, asset valuation, bankruptcy, and corporate governance. We will also consider how to disseminate such standards to member countries through our surveillance and encourage their adoption. Working with so many institutions, public and private, in addition to our 182 member countries, will be an ambitious undertaking, but we are ready—and enthusiastic—to play our full part in this new chapter in international cooperation.

In the meantime, the IMF has been applying this standards approach to one of its traditional domains of expertise: fiscal policy. Last winter, following the suggestion of the Chancellor of Exchequer, the IMF developed a code of good practices on fiscal transparency to which members will be encouraged to adhere. Looking ahead, we plan to develop a similar

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both gross and net reserves, including reserve-related liabilities and central bank derivative transactions and positions, as well as external debt and data on banking and financial sector health.

code with respect to financial and monetary policies in cooperation with the appropriate institutions.

- But despite these efforts at crisis prevention, crises may continue to arise from time to time. In this regard, the Interim Committee also reaffirmed both the central role of the Fund in crisis management and the need to develop more effective procedures to involve the private sector in forestalling or resolving financial crises.[2]

- Finally, as I have already alluded, the Committee reaffirmed its view that the time has come to add a new chapter to the Bretton Woods Agreement by making the liberalization of capital movements one of the purposes of the Fund and extending, as needed, the Fund's jurisdiction for this purpose. It requested the Executive Board to pursue its work on this issue with determination, with the aim of submitting an appropriate amendment of our Articles of Agreement as soon as possible.

Greater transparency and availability of economic information, adoption of standards and dissemination of best practices, a continuous strengthening of IMF surveillance, the orderly liberalization of capital movements, and better private sector involvement in crisis prevention and resolution—taken together and utilized to their full potential—these first five pillars could be a very significant contribution to a new financial architecture much more attune to dramatically modernized and globalized markets. I have no doubt the G7/G-8

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[2]As regards the latter, some follow-up actions are needed, including measures to discourage excessive reliance on short-term financing and strengthen countries' capacity to withstand sudden shifts in market sentiment. In addition, the Interim Committee has requested the Fund to consider other ways to strengthen incentives for creditors to use available information to analyze risks appropriately and avoid excessive risk-taking. Possibilities include introducing provisions in bond contracts regarding bondholder representation and voting in case of negotiations on bond restructuring; extending the Fund's policy of providing financing to member countries in arrears to private creditors; encouraging strong bankruptcy systems for both domestic and international capital markets; and advising member countries to exercise greater caution in granting public guarantees. We also need to examine the possibility of closer contacts with creditors in order to explain Fund arrangements and, if needed, catalyze private sector financing so as to achieve more equitable burden sharing vis-à-vis the official sector and limit moral hazard.

Establishing closer contacts with private creditors, particularly at an early stage of a crisis, raises difficult issues; thus, it is not surprising that the Interim Committee has not pronounced on this point. Among the various options, I would suggest that consideration be given to asking the appropriate authorities in each creditor country to arrange for the selection of a representative of its financial community, who could be contacted in a crisis and who could provide a channel for communicating with a wide spectrum of financial institutions.

leaders in Birmingham will invite us to build on this basis. One can even imagine that they want to point out some additional avenues, which, as we have been absorbed by more immediately pressing aspects of our work—we have not, as yet, been able to explore sufficiently.

What next?

Trying to answer the question of "what next" is a risky endeavor. No doubt with globalization unfolding its opportunities and risks, new priorities will promptly capture our attention and overtake our pre-established agendas. But it is always better to try to anticipate them, particularly when they reflect problems that should already have been addressed, be it:

- the integration of the poorest countries in the globalized economy. Asia should not distract us from the pressing problems of the poorest economies;

- the stabilization of the international monetary system; or

- the issue of the democratic accountability of international financial institutions, as far as the IMF is concerned.

The issue of the integration of the poorest countries is, of course, already on our agenda. But, true, the attention of the world has been so focused on the Asian crisis and the need to avoid its recurrence that the immense problem of development and alleviation of poverty, particularly in Africa, seems to have been put temporarily on a back-burner. This is no longer acceptable.

In this context, I was particularly happy that, in drawing the lessons of an external evaluation of ESAF, the Interim Committee encouraged us to "strengthen the ability of the Fund to foster sustained growth and external viability in poor countries." There is more than conventional rhetoric in these words. This mention, in a document essentially devoted to the handling of financial crisis, surely testifies to the recognition by the world's financial leaders that the success or failure of poor countries in finding their own way toward integration and development in an interdependent world will have a major influence on what the twenty-first century will be. This means that the solidity of our new architecture will crucially depend on the way in which, for the poorest countries, monetary and financial strategies, on the one hand, and poverty alleviation strategies, on the other hand, are made mutually reinforcing.

Poverty alleviation is chiefly, of course, the task of the World Bank, the regional development banks, and bilateral donors. Among the latter, it is quite encouraging, indeed, to see the energy and enthusiasm with which the British Minister for Development—an MP from Birmingham, as a matter of fact!—Ms. Clare Short, is promoting the DAC Target of reducing by one half the proportion of the world's population living in extreme poverty by

2015.[3] These objectives are ambitious, but they remain realistic, provided industrial countries join forces in stopping the present decline of development assistance and implement their agreed commitment to support, as needed, countries that truly own their national strategies for sustainable development. Among the latter, I would agree that particular priority be given to post-conflict countries where we must join forces to give new chances to reconciliation, peace and development. Obeying this same imperative of serving together peace and development, I would also suggest that the G-7/G-8 warmly endorse Mr. Koffi Annan's recommendation to the African Governments to reduce purchases of arms and munitions to 1 1/2 percent of GDP and maintain zero growth on defense budgets for the next decade. Industrial countries must play their full part in these efforts, and, here, I must share with you my anxiety.

Today's silence on the crisis in official development assistance is profound and distressing. It means that Africa, in particular, must rely chiefly for its economic progress on humanitarian compassion or the benefits of trade. This cannot suffice if human development is to be intensified and accelerated. Yet, at the present juncture, the macroeconomic and structural successes of recent years, precisely in the context of IMF–World Bank supported programs, are creating an opportunity that is too good to miss. Africa has found a way to advance from two decades of negative per capita growth to positive growth in more than forty of its countries. In many African countries, a new generation of leaders is seriously concerned about the need for democratization, protection of human rights, promotion of "good governance," and human development. Their efforts are in danger of falling short, however, because their domestic savings rates are still too low to finance the volume of investments needed to boost their rate of growth from approximately 5 percent to over 7 percent, which is not an unrealistic objective; it could be attained and sustained for a long time if local savings were supplemented by an appropriate mix of public and private foreign support and if a few key conditions were met, notably:

- continued modernization of the framework for private investment; and
- improvement in public governance through the total commitment of new governing teams.

Together with the World Bank and bilateral donors, we can make a difference. But a strong political impulsion by the world's leaders and the example of their countries' cooperation to development will be of the essence. May their communiqué demonstrate their vision and leadership in this domain also.

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[3] I hope I am not revealing a state secret in telling you that she inscribed this on her Christmas card!

The stability of the international monetary system has been on the agenda for more than 20 years of annual summits. The Asian crisis has highlighted how disruptive developments in exchange markets can help trigger a crisis. It is in this domain that efforts to strengthen multilateral surveillance over the international monetary system could be particularly fruitful. Moreover, the development of the euro into a key international currency could make a major contribution to stability of the overall architecture, provided that close cooperation is established among the monetary authorities of the tripolar system that might take shape. Even if it would be premature at this stage to try to elaborate further on how to maximize the positive effects of this major innovation, no doubt the new international monetary equilibrium will have to be kept under review as a key element of the new architecture. From the outset, effective means of coordination will have to be found to avoid excessive misalignments and disruptive corrections. The world is fully justified in expecting a responsible leadership from these major currencies blocs, which should be actively mindful of their global responsibility and resist the temptation of "benign neglect." Each of them.

Lastly, at a time when de facto more and more responsibilities are being given to the international financial institutions, and particularly to the IMF, the question of their political accountability will probably be raised with increasing insistence. Indeed, this question already arises from time to time, although not always with full awareness of the nature of our institutions and of the powerful checks and balances already enshrined in their Articles of Agreement. In this context, and as far as the IMF is concerned, is there anything that could be done to strengthen what one might call the political accountability or legitimacy of our institutions? At this stage, this would require at least a few organizational changes, which would make more explicit the tie that binds us to the governments we depend on. The IMF could, for instance, encourage its Governors, in general the Ministers of Finance, to become more actively involved in its work, in terms of decision-making and not merely in a consultative capacity in the Interim Committee. A similar question faces the G-7, which feels the need to embrace emerging market countries, but is unclear about how to go about it, and finds it difficult to come up with acceptable ways of choosing its partners. The design of a new architecture provides, perhaps, a good occasion to address these long-avoided questions. Two avenues could be explored.

The first would be to "revitalize" the IMF Interim Committee. It could become an essential structure, because no other can match the scope of its responsibility and the legitimacy of its members, who are collectively responsible for key developments in the world economy. At present, however, it is hampered by the ritualism of its meetings and an insufficient awareness of its uniqueness and potential. This is why I think that the suggestion of the French Minister of Finance, M. Strauss-Kahn, to consider its transformation into a "Council" with decision-making, rather than merely consultative, powers, is particularly important. This is not a new idea. This transformation, pursuant to Article XII, Section 1 of the Fund's Articles of Agreement, could give it a new start. This approach was envisaged under the Jamaica accords, but deferred at the time because of the experimental nature of the

Interim Committee. But given the daunting changes that have occurred recently in the world economy, and the fact that the IMF has achieved truly universal status with the accession of the transition countries, perhaps the time has come to consider it. Without greatly altering the operation of the institution and the pivotal role of its Executive Board, such a transformation would give the IMF renewed and very valuable legitimacy for the increasingly difficult tasks it is called upon to perform.[4]

The second avenue, in the same spirit, would consist of making provisions every two years for the G7/G-8—on the occasion of their meetings—to join the heads of state and government of the 16 countries holding seats on the IMF and World Bank Executive Boards to discuss with them and with the heads of those two institutions and the WTO the major economic and financial questions of the day. This new G-24 would have the significant merit of its basic legitimacy, as it would strictly reflect the system of international representation established for monetary and financial affairs in Bretton Woods. This would clearly represent a step forward not only in terms of dispelling the current malaise, but also in terms of hastening the adoption of integrated policy responses to the challenges of the globalized economy. The Secretary General of the United Nations should also be invited to participate to take into account the work of the entire family of UN agencies, which could become a fourth humanitarian and social pillar of the world system.

Such ideas could, of course, be met with skepticism and run up against logistical problems that may seem insurmountable. Nevertheless, they need to be discussed, as they could provide a concrete way of recognizing that each medium-sized or developing country must have a more equitable share of responsibility for the future of the world economy, a share that they believe is unjustly denied them in the present institutional arrangements of the international financial system.

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Now, at the end of this analysis of a number of key issues confronting the world economy, it is perhaps appropriate to come back for one minute to the central messages of our eminent predecessors of the *Lunar Society* two hundred years ago. I am told that they included:

- the value of drawing lessons and inspiration from various disciplines and from the experience in different countries;
- the need to establish and disseminate standards so quality would be upheld and trade would flourish; and

[4] This decision must be taken by an 85 percent majority and thus requires the active support of all G-7 members.

- a deep concern for the social implications of economic change and a keen desire to improve education;

- and, of course, a strong sense of purpose and confidence in the promises of their new world.

No doubt these messages could strike a chord with many people today, including—why not?—the stellar group that will assemble in Birmingham. May they share these approaches and concerns. Their confidence in the lasting benefits of globalization will be fully justified as a new world, born from the opening of economies, the unification of markets, and the universal availability of information and knowledge, has an immense potential for high-quality growth. May they also validate their own message of confidence by a clear demonstration of their sense of universal responsibility and solidarity.