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Introduction

The 1990s have seen a spate of currency and financial crises affecting emerging-market countries, the frequency and severity of which have raised serious doubts about the stability of financial markets facing these countries as they open their economies and integrate with the rest of the world. This in turn has sparked the search for a new financial architecture which would reduce the degree of instability in the system and improve its capacity to handle instability when it arises.

Recognition of the potential instability in the system was slow in coming, despite early warnings. The ERM (Exchange Rate Mechanism) crisis of 1992 was a pointer to what lay ahead, but it did not generate calls for systemic reforms because it was primarily a currency crisis and the industrialised countries affected did not experience a generalised financial crisis with disruptive effects on the real economy. Two years later, when the fiftieth anniversary of the Bretton Woods Agreement was celebrated and the functioning of the international financial system was subjected to in-depth examination, there was relatively little concern about instability. The developing countries raised familiar concerns about the system's inability to assure an adequate flow of resources for development and structural adjustment, but the dominant view among industrialised countries was that the system was functioning well and no major changes were needed.

The Mexican crisis in 1994 was a full-fledged currency, cum financial, crisis which should have signalled the need for a systemic overhaul, but the warning was muted primarily because the crisis was handled well and Mexico made a quick recovery. The crisis did highlight the special problems posed by currency crises arising in a situation of financial fragility, the interaction between the two, and also the problem of contagion (the tequila effect). However, although these issues began to receive attention in academic and official forums, the problem was not seen as a potential threat facing most emerging markets and possibly even undermining the stability of the international financial system.

The East Asian crisis in 1997 was the real watershed in this respect. The international financial system was seen to have malfunctioned seriously. Some of the best-performing developing countries, which had been regarded as exemplars for others to emulate, were plunged into a crisis of exceptional severity with little warning. One of the worst hit countries, Korea, was not even a developing country, having recently graduated to industrialised country status.

Reacting to East Asia, the USA took the initiative of convening an ad hoc group of 22 industrialised and emerging market countries (originally called the Willard Group after the Washington DC hotel in which they met, and later re-christened the G-22) to discuss the issue of financial instability affecting the international financial system. These consultations, held in April 1998, can be said to mark the official start of the search for the new financial architecture, which was first pursued in three Working Groups set up by the G-22, and later in other inter-governmental forums and the Bretton Woods Institutions themselves.

The urgency to put a new architecture in place increased sharply after the Russian crisis in August 1998 and its ripple effects in Wall Street in the form of the collapse of Long Term Capital Management (LTCM). Emerging-market crises were no longer just distant events but were seen

to have repercussions which could affect major financial markets in industrialised countries. Fears about the stability of the system intensified later in the year when the Brazilian Real came under attack, and it looked as if an East Asian style currency collapse might sweep over Latin America. The threat of an international financial meltdown, which could do irreparable damage to international capital markets, did not seem too remote.

Predictably, the crisis atmosphere produced a wide variety of reactions and suggestions. The International Monetary Fund (IMF) came in for intense criticism from different perspectives. Some critics, for example Friedman (1998) and Schultz, Simon and Wriston (1998) complained that the Fund actually helped create crises because of the moral hazard generated by its bail-out operations and that the institution should therefore be abolished. Others such as Radelet and Sachs (1998) criticised it for prescribing the wrong policy mix which had not only failed to handle the crisis, but actually made things worse than they need have been. Calomiris and Meltzer (1998) advanced proposals to restructure Fund lending practices so that the danger of moral hazard would be minimised. There were proposals for creating entirely new institutions such as a new world central bank (Garten, 1998), a world financial authority (Kauffman, 1998) and an international credit insurance corporation (Soros, 1999). Prime Minister Tony Blair of the United Kingdom, speaking at the New York Stock Exchange in October 1998, called for a Bretton Woods for the new millennium, which seemed to suggest that wide-ranging changes in the system were needed and might even be politically acceptable.

The mood began to change in the course of 1999 as fears of a financial melt-down abated. The East Asian economies began to recover faster than expected, with Korea rebounding much more vigorously than anyone had thought possible. Brazil also stabilised more easily than was at first expected and the danger of contagion in Latin America was effectively contained. As financial markets calmed down, the appetite for radical reform of the international financial system also declined. Signalling the new perception in their meeting in Cologne in June 1999, the G-7 Finance Ministers explicitly ruled out the creation of any new institutions and made it clear that their aim would be to work with the existing system, strengthening it where necessary.

There is nothing wrong with incremental change as long as it yields positive results; this monograph attempts to evaluate the outcome of the discussions from this perspective. It identifies the key issues in reforming the international financial system and the extent of consensus in each area, and provides an assessment of the extent to which the initiatives being considered will help make the system less vulnerable to crises. Chapter 2 describes some of the critical features of contemporary financial crises and the reasons why developing countries are especially vulnerable to such crises. Chapter 3 reviews the major proposals emerging from the new architecture discussions which are aimed at reducing the probability of crisis occurring, i.e. crisis prevention; while Chapter 4 examines mechanisms which have been proposed for dealing with crises after they occur, i.e. crisis resolution. Chapter 5 deals with the need for an appropriate governance structure for the emerging international financial system and stresses the importance of ensuring effective representation for all stakeholders including the developing countries.

An important limitation of the new architecture discussions, which should be noted at the outset, is that they focus narrowly on the problem of protecting emerging market economies from financial crises. Other deficiencies in the functioning of the international financial system, which are also of concern to developing countries, have not been addressed in these discussions. For example, the increased volatility of exchange rates among the major currencies, witnessed after the collapse of the Bretton Woods

system in the mid-1970s, has long been felt to create an adverse external environment for the developing countries, but this issue is not addressed. Other issues of concern are the declining levels of aid and stagnation of other official flows, the high burden of debt for many low-income countries, in the face of poor export prospects, and declining primary product prices. There is also the problem that private capital flows, which are often presented as a reliable and plentiful source of external capital which can substitute for declining official flows, are in practice concentrated on a relatively small number of developing countries. All these issues have been on the international agenda for some time, but they are not on the agenda of discussions on the new financial architecture and therefore are not dealt with in this monograph.