Safeguarding Prosperity in a Global Financial System

The Future International Financial Architecture

Report of an Independent Task Force Sponsored by the Council on Foreign Relations

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EXECUTIVE SUMMARY

INTRODUCTION

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 nose-dived, 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 a year ago, *characterized the Asian/global 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*

Certain passages in the executive summary are italicized to highlight the task force's main findings and recommendations.

was at least a tenth—and sometimes much more—of the crisis country's annual national income. As bad as it was, the US savings and loan crisis of the late 1980s cost US taxpayers about 2-3 percent of our 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 devaluation of the peso 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.

We cannot eliminate banking, currency, and debt crises 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 ("the architecture" for short)—is also very much in our national interest. The US 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 our 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 our exports go to developing countries. US 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 US savings is invested abroad. Borrowing costs, including the monthly payments US households make for their home mortgages, are lower because of our participation in international capital markets.

But why worry, some might ask. After all, *the US economy has continued to perform impressively throughout the latest crisis*

period. So it has. But to conclude that fragilities in the international financial system are somebody else's problem would be dangerously complacent. In the recent emerging-market crisis, *US 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 our 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 we might not be so well positioned to weather the storm.*

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

OUR APPROACH

If we are *to make real headway in improving crisis prevention and management in the developing world, we must put the primary responsibility back where it belongs: on emerging economies themselves and on their private creditors, which 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 our analysis. We wanted to:

1. Encourage emerging economies to intensify their crisis prevention efforts.
2. Permit savings to flow to the countries and 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 IMF and the World Bank on areas they are best equipped to address.

Consistent with these principles, *we offer seven key recommendations:*

Recommendation 1. Greater rewards for joining the "good housekeeping club." The IMF should lend on more favorable terms to countries that take effective steps to reduce their crisis vulnerability and should publish assessments of these steps for each country so the market can take note.

Recommendation 2. Capital flows—avoiding too much of a good thing. Emerging economies with fragile financial systems should take transparent and nondiscriminatory tax measures to discourage short-term capital inflows and encourage less crisis-prone, longer-term ones, such as foreign direct investment.

Recommendation 3. The private sector: promote fair burden-sharing and market discipline. To encourage more orderly and timely rescheduling of private debt where it is needed, all countries should include "collective action clauses" in their sovereign bond contracts. In extreme cases where rescheduling of private debt is needed to restore a viable debt profile, the IMF should require as a condition for its own emergency assistance that debtors be engaged in

"good faith" (serious and fair) discussions on debt rescheduling with their private creditors. The IMF should also be prepared to support a temporary halt in debt repayments.

To reduce moral hazard at the national level, the IMF should encourage emerging economies to implement a deposit insurance system that places the primary cost of bank failures on bank shareholders and on large, uninsured private creditors of banks—and not on small depositors or taxpayers.[1]

Recommendation 4. Just say no to pegged exchange rates. The IMF and the Group of Seven (G-7) should advise emerging economies against adopting pegged exchange rates and should not provide funds to support unsustainable pegs.

Recommendation 5. IMF crisis lending: less will do more. For country crises, the IMF should adhere consistently to normal lending limits. This will help to reduce moral hazard at the international level. For systemic crises, the IMF should turn to its existing credit lines when problems are largely of the country's making and to special contagion funds when the country is an innocent victim.

Recommendation 6. Refocus the IMF and the World Bank: back to basics. The IMF should focus on monetary, fiscal, and exchange rate policies plus financial-sector surveillance and reform and stay out of longer-term structural reforms. The World Bank should focus on the longer-term structural and social aspects of development, including the design of social safety nets. It should stay out of crisis lending and management.

Recommendation 7. Generate political support for and ownership of financial reforms. Convene a global conference of finance ministers to reach a consensus on actions, priorities, and timetables for actions nations will take to strengthen national financial systems.

[1]By "moral hazard," we mean situations in which the availability of insurance from the official sector weakens investors' and borrowers' sense of responsibility for their own actions.