

Lamberte, Mario B.

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Reforming the International Financial Architecture: The East Asian View

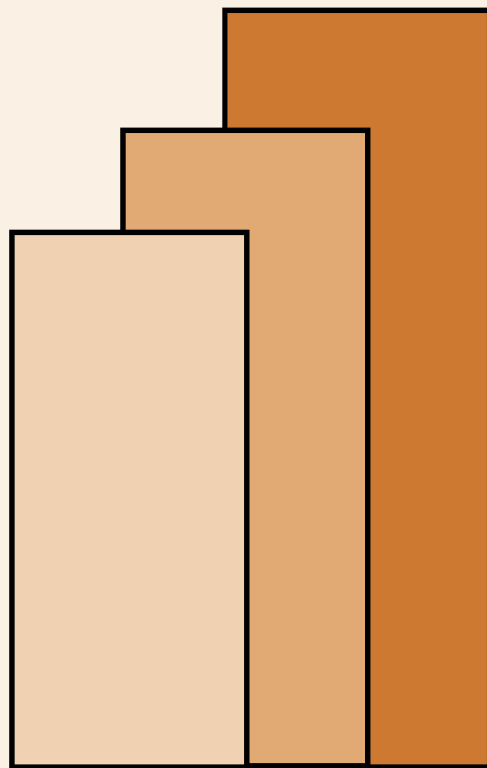
Mario B. Lamberte

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For comments, suggestions or further inquiries please contact:

The Research Information Staff, Philippine Institute for Development Studies
3rd Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines
Tel Nos: 8924059 and 8935705; Fax No: 8939589; E-mail: publications@pidsnet.pids.gov.ph
Or visit our website at <http://www.pids.gov.ph>

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE



THE EAST ASIAN VIEW

Mario B. Lamberte, Ph.D.
President
Philippine Institute for Development Studies

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE: THE EAST ASIAN VIEW¹

*Mario B. Lamberte, Ph.D.*²

Abstract

Despite the measures that have already been put in place to strengthen the international financial architecture in the wake of the Asian financial crisis, still much remain to be done. This paper tried to distinguish developing economies' views, in general, and East Asian views, in particular, on reforming the international financial architecture from the G7 and G7-led institutions' views and found substantial differences. From East Asia's and developing economies' perspective, the present discussions on reforming the international financial architecture that take place mainly within G7 and G7-led institutions are unlikely to lead to solutions for the prevention of future crises. East Asia's and developing economies' concern regarding the governance structure for reforming the international financial architecture and the Bretton Woods Institutions, establishment of regional financial arrangement, and some of the substantive aspects of the proposed reform package deserve to be given utmost consideration in discussions on strengthening the international financial system.

Key words: *international financial architecture; regional financial arrangement; exchange rate regime; capital account liberalization; G7; G20; G22; G24; international standards; private sector involvement; Bretton Woods Institutions.*

I. INTRODUCTION

The foundations of the international financial architecture (IRA) were shaken by the Mexican crisis, which was followed by a much more severe crisis that struck Asian economies and other emerging market economies. Today, it looks like the leaning tower of Pisa. Like the leaning tower of Pisa, the international financial architecture has attracted a lot of curious onlookers and analysts wanting to offer solutions to fix it. If we go over the voluminous articles on reforming the international financial architecture, we cannot but agree with Eichengreen's (2000) observation that this topic has become a

¹ A preliminary draft of this paper was presented at the KIEP/NEAEF conference on Regional Financial Arrangements in East Asia: Issues and Prospects, East-West Center, Honolulu, Hawaii, 10-11 August 2000.

² President, Philippine Institute for Development Studies. The author thanks Ms. Sharon Thea Vital and Ms. Juanita Tolentino for their excellent assistance in preparing this paper.

major industry. Indeed, several reports from individuals, research institutions, fora, NGOs, and official national and international bodies come out every day. It is perhaps the only industry today whose growth rivals that of e-commerce. This is not to say that nothing concrete yet has been done to reform the international financial architecture. On the contrary, if we go over the latest report of the Deputy Managing Director of the IMF circulated on 12 April 2000, we can immediately observe that much has already been accomplished to reform the international financial architecture. However, judging from the issues currently being intensely debated, it seems that there are still a lot of issues related to the strengthening of the international financial architecture that have remained unresolved.

This paper discusses current issues on reforming the international financial architecture in the East Asian context. The questions it seeks to answer are: What are the desirable ways to reform the international financial institutions (IFIs)? What is likely to be achieved? In light of the experience of the Asian financial crisis, can the present discussions, which are taking place mainly at G7 and G20 meetings, prevent future crises in an effective way?

To answer the questions posed above, we need to distinguish developing economies' views, in general, and East Asian views, in particular, from the G7-led views. While it is not difficult to assemble the G7-led views since most of them can be culled from the various reports of G7 and G7-led institutions, the same cannot be said of the developing economies' and East Asian views since there is no single institution like the G7 that organizes and communicates their views. Our approach, therefore, is to gather relevant papers produced by various groups, fora and individuals that, in our judgment, tend to reflect the developing economies' views in reforming the international financial architecture. Although some of the developing economies' and East Asian views on certain issues have converged, however, their views on other issues have differed. We, therefore, try to put emphasis in this paper on similar views expressed by developing economies and, in certain instances, mention some of the divergent views.

The next section briefly reviews the recent performance and prospects of East Asian economies with special focus on the crisis-hit economies. The third section discusses the G7-led views and developing economies' views as well as East Asian economies' views on issues related to reforming the international financial architecture. Considering the wide array of issues being debated, we focus only on what we think are the major ones that directly relate to East Asian views on reforming the international financial architecture. The last section attempts to make a general assessment of the

effectiveness of the present discussions in preventing, managing and resolving future crises.

II. RECENT PERFORMANCE AND PROSPECTS OF EAST ASIAN ECONOMIES

The crisis that struck in mid-1997 had interrupted the consistently high growth rates enjoyed by East Asian economies in the previous decade. Hardest hit by the crisis were Indonesia, Hong Kong, Thailand, Korea and Malaysia (**Table 1**). The stabilization measures adopted by crisis-hit countries successfully brought down inflation rate in 1999 (**Table 2**) and paved the way for the remarkable recovery of their economies. The resumption in growth enabled East Asian economies, particularly the crisis-affected economies, to quickly rebuild their foreign exchange reserves to a level much more comfortable than the pre-crisis levels (**Figure 1**).

Forecasts made by the Pacific Economic Cooperation Council (PECC) suggest that the recovery of crisis-hit and other East Asian economies will likely be sustained in 2000 and 2001, with GDP growth rates ranging from 1.2 percent to 8.5 percent and 2.1 percent to 7.6 percent, respectively. Of course, these forecasts are anchored on the assumption that East Asian economies, particularly those badly hit by the crisis, would continue the reforms they had started in 1997 to strengthen their economies and that no negative external shocks (e.g., recession in the US and Europe, further increases in the price of oil, etc.) would occur in the near term. Indeed, there are indications that the recovery currently enjoyed by East Asian economies is still fragile. First, the recovery of crisis-hit economies was partly underpinned by expansionary fiscal measures (pump priming and rescue operations of ailing private financial institutions and corporations), resulting in higher budget deficits (**Table 3**). These countries will have to address this problem in the next two years to build a strong foundation for sustained recovery. Second, non-performing loans of commercial banks of crisis-hit countries have still remained at uncomfortable levels, constraining banks to expand credit to the private sector (**Figure 2**). Third, after rebounding in 1999, private capital flows had considerably slowed down in the first two quarters of 2000 (**Figure 3**). Fourth, the growth in exports, which is largely powered by the electronics sector, can be undermined by the continued softening in the demand for electronic products in the US (**Figure 4**).

Most recently, East Asian financial markets are again undergoing some turbulence. With the exception of Korea and Malaysia (which fixed its exchange rate), Asian currencies depreciated from a low of 4 percent in Singapore to a high of 23 percent

in Indonesia during the first half of 2000 (**Table 4**).³ Stock market indices of Indonesia, Korea, Philippines, Singapore and Thailand plunged by 16 percent to 34 percent. This has exerted a lot of pressure on domestic interest rates, which already started to inch up for most of the East Asian countries during the indicated period. ADB (2000) attributed the recent turmoil in the Asian financial markets to both external factors, specifically the rising US dollar interest rates, and internal factors, such as perceived lack of progress with ongoing corporate and banking restructuring and other reforms and political instability in the case of Indonesia and the Philippines. In response to the recent financial market turmoil, East Asian economies have put additional measures to curve speculative attacks on their financial markets.⁴ Although ADB thinks that the region is not undergoing a “mini-crisis” due to strong economic fundamentals and healthy foreign exchange reserves, still the volatility in the exchange rates and rapid deterioration in the value of Asian equities during the first half of 2000 suggest the need for East Asia to take a harder look at the ongoing reforms of the international financial architecture. The “V”-shaped recovery of crisis-hit countries in East Asia should not be allowed to breed complacency.

III. THE MAJOR ISSUES BEING DEBATED

We take as our starting point Culpeper’s (2000) definition of international reform, which “is any reform to relationships between participants (public or private) in the international market, or to international institutions governing those relationships.” However, we would like to stretch the definition to include domestic reforms, which are required due to changes in international relationships so that each participant in the global economy can fully benefit from a stable international financial system. The reforms are needed because cracks have appeared in the domestic financial systems of participating economies, in cross-border financial transactions, and in the international financial institutions. For East Asia, the first major question is: Who is going to write the job specifications for repairing and strengthening the international financial architecture? In other words, what should be the appropriate governance structure for reforming the international financial architecture. The second major question is: What should be the job specifications for repairing the international financial architecture? In other words, what specific issues should be addressed to strengthen the international financial architecture? From the perspective of developing economies, in general, and East Asia, in particular, the major issues are: capital account liberalization and management of

³ The exchange rate volatilities have remained unabated at the time of the writing of this paper.

⁴ For instance, the Philippine central bank has tightened the reporting requirements on foreign exchange transactions of banks and their affiliates.

capital flows, exchange rate regime, international standards, strengthening the financial system and capital adequacy framework, the role of highly leveraged institutions (HLIs) and credit rating agencies, private sector involvement, the role of the Bretton Woods Institutions (BWIs), and regional financial arrangement (RFA).

We will discuss below each of the above-mentioned issues.

1. Governance Structure for Reforming the International Financial Architecture

The Bretton Woods institutions (BWIs) have been overseeing the international financial architecture since their creation in 1944. They have been adapting to changes in the international financial market. The World Bank was originally established to finance post-war reconstruction in Europe. When that mission was completed, it turned to promoting economic development in developing countries by funding projects and supporting structural reforms. The IMF, on the other hand, was originally designed to support the Bretton Woods system of fixed exchange rates. When the system collapsed in the 1970s and a number of countries, including the major industrial countries, adopted a floating rate system, the IMF turned to assisting countries with flexible exchange rates. In the 1980s, a number of Latin American countries encountered difficulties in repaying their loans to banks in developed countries. The IMF played a major role in coordinating orderly restructurings of government debts owed to the private banks.

The 1990s posed new challenges to the BWIs. With globalization, financial markets including those of emerging economies have become more integrated with the rest of the world. Cross-border movements of capital had grown rapidly in the last decade, greatly benefiting emerging economies. However, sudden shifts in investor confidence caused a massive reversal of capital flows, immediately plunging several emerging market economies into a severe balance of payments crisis. Clearly, the crises that recently appeared in Mexico and East Asia, which later on spread to Brazil and Russia, emanated not from the current account but from the capital account of the balance of payments. As pointed out by Mr. Martin, the Finance Minister of Canada (2000b), these crises arise in stunning regularity, more virulent and contagious than in the past and have the potential to disrupt the entire international financial system. Understandably, the IMF's traditional instruments that worked well in dealing with current account imbalances were ineffective in dealing with crises originating from the capital account (Yoshitomi and Ohno 1999). In addition, the resources required to prevent and resolve such crises quickly were far more in excess of what the IMF could provide.

There was, therefore, a clear need to reform the international financial architecture. As already mentioned above, a lot of proposals on this issue have been put forward. The issue is who should take the lead in reforming the international financial architecture? More specifically, who should set the agenda, provide the environment for open, frank and intelligent debate on the relevant issues, organize the decision-making process and implement the decisions being made? Ideally, the IMF should take on the driver seat in reforming the international financial structure. However, its legitimacy has been undermined by its poor track record in forestalling and managing the recent crises. In addition, its huge bureaucracy can easily deflect the real issues and slowdown the reform process.

Right after the Mexican crisis, the G7 took this challenge during the Halifax meeting in June 1995. This is significant for the international community in the sense that the G7, which consists of seven highly industrialized countries, of which five have the largest quotas and are appointed members of the Executive Board of the IMF, can greatly influence the form and substance of the reform agenda (see **Table 5**). Their initial agenda for reform were modest, focusing on issues, such as, establishing early warning system and strengthening surveillance, establishing new, quick-disbursing financing facility at the IMF, and strengthening financial market supervision and regulation. As the debates on reforming the international financial architecture intensified, the G7 responded by widening their reform agenda, and in some cases, loosening up their views on certain hotly debated issues, such as capital controls and regulation of highly leverage institutions (HLIs). As observed by Porter (2000), “[W]hile much of the G7 involvement was initially limited to general statements of intention, it subsequently became increasingly detailed, specific, and associated with identifiable outcomes.”

The dominance of the G7 in the debate and its strong influence on the BWIs have accelerated the reform process, especially right after the Asian crisis.⁵ However, this has alarmed many developing economies, which felt that they are being marginalized in the most important reform process that will have far-reaching consequences on their economies (e.g., G24 1998a). Also, as clearly demonstrated by the Asian crisis, the economic activity of developing economies has substantial influence on the global economy. There are those who defended the G7. For example, Dale (1998) argued that “[T]he G7 was never meant to be representative, but to be a caucus of like-minded advanced democracies.” However, it would make a lot of difference if they were pushing

⁵ Ten industrialized countries control about 54 percent of the IMF votes.

for a reform agenda that would have implications worldwide and would require other countries to implement them.

In response to the above criticisms, the US took the initiative of forming an *ad hoc* group of 22 countries (G22), which included the G7 member countries, Australia and 14 developing and emerging market economies. This was the first informal forum of highly industrialized and developing economies that discussed world financial problems. However, it turned out that its agenda for reforms were very narrow, focusing mainly on what developing countries should do to reduce vulnerability to a crisis (see **Annex A**).

In 1999, the G7 created what Mr. Martin called two permanent “virtual” institutions, namely the Financial Stability Forum (FSF) and the G20, which replaced the US-initiated *ad hoc* G22. The FSF was designed to bring together with the G7 all the international bodies that have something to do with international financial regulation (see **Annex B** for details). In other words, it will be dealing with highly technical issues of the international financial architecture (see **Annex C** for the initial tasks). This forum includes a few East Asian economies, viz., Hong Kong and Singapore, that are *actively active in the global financial markets*.⁶ In its third meeting held in Singapore last March 2000, the FSF endorsed the recommendations of the three Working Groups on HLIs, capital flows and offshore financial centers, and the G7 Finance Ministers adopted them.

The G20, on the other hand, was created in fulfillment of the commitment by the G7 leaders at the June 1999 Summit meeting at Koln “...to establish an informal mechanism for dialogue among systematically important countries within the framework of the Bretton Woods institutional system.” (underscoring added).⁷ It has a broad mandate, which is to promote discussion, study and review policy issues among industrialized countries and emerging markets with a view to promoting international financial stability (G20 1999). Accordingly, the G20 will fill the need for representation from emerging markets in a forum that will discuss virtually all major aspects of the global economy or international financial system (Martin 2000a). Handpicked by the G7, the members of the forum represent more than 85 percent of the world’s population and 65 percent of the world’s gross domestic product (Martin 1999).

In its first meeting in Berlin last December 1999, the G20 has agreed to a focused agenda aimed at reducing vulnerabilities to international financial crises. The four priority areas are:

⁶ See Table 5 for the members of the FSF.

⁷ See Table 5 for the members of the G20.

- A comprehensive stock-taking of progress made by all member nations in reducing vulnerabilities to crises;
- An evaluation by countries of their current compliance with international codes and standards in the areas of transparency and financial sector policy;
- The completion of Reports on Observance of Standards and Codes (Transparency Reports) and Financial System Stability Assessments by the IMF with the cooperation of the World Bank; and
- An examination of differing exchange-rate regimes and their role in cushioning the impact of international financial crises.

Although the fora were designed as deliberative, rather than decisional institutions, still, the two permanent “virtual” institutions are expected to dominate the debate and decisions to be made by international bodies to reform the international financial architecture. Understandably, this has drawn some reactions from developing countries, particularly those that have not been included in both institutions. They raised three issues: the appropriateness of the fora, representation in said fora, and manner of selecting representatives. For instance, the G24 (2000) states that:

*“Ministers are concerned about the increasing role being taken in international monetary and financial affairs by international fora other than the BWIs in which the representation of developing countries is limited. The work of these fora has a direct bearing on developing countries. Therefore, Ministers urge that such issues should be considered within the BWIs, given their universal membership, and that agreements be reached in their decision-making bodies.”*⁸

Prime Minister Mahathir also questioned the lack of representation and manner of selecting the representatives to the two institutions, saying that the G7 only wanted to get people who can agree with them (Bangkok Post 2000). He was, therefore, pessimistic about what both fora could achieve. The adequate representation of emerging market economies in said institutions is important in determining the agenda for reforms and in ensuring their acceptance of the needed reforms. For Prime Minister Mahathir, the G20’s agenda should not be limited to promoting information exchange and coordination among national authorities, international institutions and international regulatory or relevant expert groupings but should pay greater attention to the need to address volatility of capital flows, particularly through direct regulation of HLIs.

⁸ See below for related views of developing economies on establishing international standards and reforming the BWIs.

2. Capital Account Liberalization and Capital Controls

It has been widely held that the process of globalization will continue and eventually presently closed economies will have to embark into full current account and capital account convertibility. However, one of the important lessons learned from the Asian crisis is that for a country to benefit from globalization, the capital account should be carried out in an orderly and well-sequenced manner in tandem with the degree of development of the domestic financial sector and supervisory regime. While there is consensus on this issue, however, there are differences in views as to how best to approach it. The G7 wanted to amend the IMF Articles to give it a specific mandate to promote capital account liberalization. In contrast, Jalan (1999) and the UN Task Force (1999) argued for the preservation of autonomy of developing and transition economies with regard to capital account issues. It is to be noted that a significant number of member countries have already liberalized their capital account before the Asian crisis. The IMF (2000c) has been conducting surveillance of capital account development under Article IV consultations and has acknowledged that there is no single approach to ensure success of liberalizing the capital account.

There is now broad international consensus that excessive short-term inflows can be a source of potential vulnerabilities. However, there is still a debate on how short-term inflows can be moderated or restrained. The FSF (April 2000e) has cautioned policy makers to consider first “a full range of policy alternatives before deciding to introduce controls” and if they decide to impose capital controls, they should “examine the objectives of such controls and assess their costs and benefits relative to alternative means of achieving the same objective.” In contrast, the United Nations Task Force (1999) argued that “developing and transition economies should retain the right to impose disincentives or controls on capital inflows...” For its part, the Asian Policy Forum (APF) pointed out that there is a need for Asian economies to impose controls on short-term flows while they are in the process of strengthening their financial systems. The G24 has expressed the same view.

Regarding the means of controlling capital inflows, the United Nations Task Force is open to various instruments, including the imposition of various taxes on capital inflows. It considers these instruments to be *permanent* “as long as international financial markets remain volatile and domestic economic structures are weak.” In contrast, both the FSF and APF consider only market-based regulations such as the Chilean-type of capital control, which imposes unremunerated reserve requirements and

minimum holding periods on capital inflows that could be varied depending on the magnitude of capital inflows and the general condition of the economy. They view this capital control as *temporary* that can be lifted once the domestic banking systems of developing economies are strengthened.

There is no consensus yet with regard to the need for imposing controls on capital outflows. The FSF avoided discussing this issue, except to say that Malaysia's experience with this type of control deserves to be studied well. When applied during normal economic conditions, controls on capital outflows can act as controls on capital inflows. However, during periods of massive capital outflows, such controls can be considered as a self-help defensive move that can substitute for an international bail-out to stabilize the economy. In his assessment of the Malaysian model of levies on capital outflows, Sakakibara (2000) considered it successful in stabilizing the economy, which gave Malaysian authorities some breathing space to address weaknesses in its banking system and corporate sector. He pointed out that such controls do not make Malaysia a closed economy, as trade, investment and portfolio investments have continued to take place into the country.

The effectiveness of the Malaysian type of capital controls hinges on the administrative capacity of regulatory institutions to strictly enforce the regulations and on a disciplined banking system. The level at which the exchange rate is fixed is important so as not to give opportunities for a parallel market to emerge. Transparency of the measures and efforts exerted to inform the general public of the measures can greatly help in improving the effectiveness of the controls. Finally, the credibility of these measures also depends on the efforts exerted by the authorities to strengthen the banking system. However, the lessons that can be drawn from the Malaysian case are still incomplete. Malaysia's exit strategy is not yet clear and there is no guarantee that once an exit strategy is adopted, Malaysia can successfully manage it.

3. Exchange Rate Regime

It is now part of the conventional wisdom that the *de facto* dollar-peg system adopted by many East Asian economies, along with massive inflows of capital, contributed to the Asian crisis. This, together with the emergence of the Euro zone, has prompted policy makers to search for the most appropriate exchange rate regime for emerging market economies. The G7, ASEAN and the G24 all agree that there is no

single exchange rate regime that is suitable for all countries.⁹ The appropriate exchange rate regime for a country may also vary over time depending on changes in economic conditions. The bottomline is that the exchange rate regime chosen by a country must be supported by sound, consistent and credible macroeconomic policies. On closer look, however, the G7 seems to be leaning towards greater flexibility in the exchange rates for developing economies when it calls on the international community to refrain from providing large-scale official financing for a country intervening heavily to support a particular exchange rate level, except in certain circumstances. In contrast, the ASEAN and G24 insist that countries have the right to choose their own exchange rate regime and that the Fund's financial support to them should not be based on the choice of any particular exchange rate regime.

In the wake of the financial crisis, most East Asian economies have moved towards a more flexible exchange rate regime, which could expose them to greater volatility in the exchange rates. As experienced by East Asian economies in the last few months, small open economies can become highly vulnerable to large swings in the major currencies. Thus, the Ministry of Finance and Economy of the Republic of Korea (1999) has pointed out that “maintaining exchange rate stability among major international currencies is becoming important for global financial stability, let alone that of crisis-hit countries.” The G24 (1999b) echoes this view but goes further by calling for “closer surveillance of the major industrial countries, including on the international implications of their domestic policies.” On the premise that the objective of cooperation among three industrial economies is not to defend a certain exchange rate level but to promptly correct overshooting or misalignment, Gyohten (1999c) proposed the following multi-stage plan for ensuring stability of the exchange rates among the three leading currencies:

- a. Monetary authorities of the US, Japan and the EU and the IMF will make a joint public commitment that they recognize stability among the three currencies, namely the dollar, yen and euro, is desirable.
- b. The four parties will establish a stabilization council to meet at least once every quarter or more often as required by circumstances to monitor international trends and determine if action is needed.
- c. The council must reach a consensus on the reasonable or permissible level or range of exchange rates among the three currencies at that point in time.¹⁰

⁹ See Report of G7 Finance Ministers to the Koln Economic Summit (1999a); ASEAN's Position on the Reform of the International Financial Architecture (1998); and G24 Communique (1999b).

¹⁰ According to Felix (1999), limiting fluctuations between the Big Three currencies is a looser equivalent of the Bretton Woods exchange-rate regime, which relied on the fixed-dollar price of gold.

- d. When the market exchange rate deviates from the agreed level or range and, judging from the speed or momentum of the deviation, there is a danger of overshooting, the four parties must decide on and execute a measure to prevent or correct the overshooting.

As regards exchange rate regime for other countries, the APF (2000) does not consider either the freely floating exchange rate regime or the currency board regime as appropriate for emerging Asian economies with open capital accounts. The track record of Asian economies in containing inflation does not give them any reason to adopt a currency board system at the expense of domestic monetary autonomy. On the other hand, freely floating exchange regime has two potential problems: volatility of the exchange rates in the short-term and misalignment of exchange rates in the medium-term. East Asian emerging economies have still relatively underdeveloped financial markets, which offer very limited hedging possibilities and can be easily subjected to manipulation by large players. Surges in capital inflows can lead to an appreciation of the currencies, inducing more capital inflows and hence more appreciation of their currencies. This exchange rate misalignment could last for some time and lead to misallocation of resources. In view of these, the APF has recommended that:

“Emerging Asian economies with open capital account adopt a managed float exchange rate policy, which would be consistent with sustainable international competitiveness and also would allow sufficient exchange rate flexibility but would avoid a serious exchange rate misalignment caused by persistent capital movements. The exchange rate compatible with competitiveness can be based on an appropriately trade-weighted currency basket rather than a single currency, adjusted appropriately for differences in international inflation rates.”

This exchange rate regime is similar to what Singapore has adopted since 1981 (Peng 1999). Since Singapore has adequately dealt with the Asian crisis, it is certainly worthwhile for other emerging Asian economies to consider this exchange rate regime. However, given the diversity of the foreign exchange rate regimes in East Asia, the Subcouncil on the Revitalization of the Asian Economy and Financial Markets (2000) of the Ministry of Finance of Japan has suggested that the countries in the region that want to move to the trade-weighted currency basket exchange rate regime should proceed in a coordinated manner. Otherwise, if only one country does it, there is a risk that it will be placed at a disadvantage in terms of international competition if the dollar weakens against other currencies in the basket.

For countries that still have closed capital account, the APF has recommended that they pursue an adjustable peg exchange rate policy and give a high priority to building a strong banking system and sound long-term securities markets.

4. International Standards

A broad international consensus has already been reached with regard to the need for developing codes, standards and practices that could strengthen the international financial architecture. Substantial progress has been made in this area in the last three years, especially in developing codes for enhancing transparency of the public, private sector and multilateral institutions. The Fund's codes of good practices on fiscal transparency and on transparency in monetary and financial policies have already been disseminated. The Basle Committee, IOSCO and the IAIS have established core principles for supervision in their respective areas of responsibility. It is to be noted that many of the standards that have been developed, e.g., accounting, auditing, bankruptcy, capital adequacy, etc., need to be implemented at the corporate level.

The current debate on this aspect of reforming the international financial architecture centers on two issues: participation of developing economies and implementation. Developing economies have called for participation in international fora or bodies that formulate international standards, which are going to be incorporated in their national regulatory and supervisory regimes and affect the way they conduct economic policies and monitor and supervise specific segments of the economy. These international bodies have recently progressed from standards-setters for their members, which mainly consist of industrial countries, to global standards-setters. This naturally raises questions on the representativeness of these bodies in as much as they expect their standards to be applicable to both developed and developing economies. Cornford (2000) cites the case of the Basle Committee's work on rules regarding capital adequacy.¹¹ The participation of developing economies in these bodies can certainly enhance the quality, credibility and effectiveness of international standards.

As regards implementation, the G7 is determined to promote the implementation of internationally agreed codes and standards. It sent a clear signal to the international community when it stated that:

¹¹ This is discussed in detail below.

“As part of policy review, they should enhance surveillance over the broad range of policies now understood to be crucial to financial stability. Countries should be encouraged to demonstrate their commitment to making rapid progress towards full compliance with existing international codes as part of IMF and World Bank conditionality when the IFIs extend loans or credits.” (G7 1999b).

It is worthwhile to emphasize the point that the G7 wants ***rapid progress towards full compliance*** and inclusion of such standards in the World Bank and IMF ***conditionality***. The same message was repeated in the July 2000 report of the G7 Finance Ministers to the Heads of State and Government.

In contrast, developing economies prefer voluntary and gradual adoption of international standards rather than a faster one. The following statements of the G24 (2000) articulates well this view: “While they welcome the development of international codes, standards, and best practices, Ministers consider that the scope of surveillance should not be extended to cover the observance of such standards and codes, which should remain a voluntary choice by each member.” The same view is echoed by the Ministry of Finance and Economy of the Republic of Korea (1999).

The adoption of international standards must be in step with the capacity of national regulatory authorities, which can only be built over time through training. It should be noted that it took developed economies a very long time to develop the capacities of their regulatory authorities, which even now are not a guarantee that theirs is a completely fail-safe system for preventing a financial crisis. The recent LTCM debacle amply demonstrates this point. Recognizing this problem, the G7 countries have expressed their keen interest in working together and with the IFIs, the FSF, and international regulatory and supervisory bodies to provide technical assistance and training to emerging market and developing economies in this area (G7 2000b). But realities in developing economies must be considered in any program to encourage them to adopt the international codes and standards. As Cornford (2000) pointed out,

“the problems for national policy are not limited to expanding training. As supervisors acquire the new skills (which will often include most or all of those required of auditors, for example), the public sector will often find itself competing for their services with banks and accounting firms capable of offering substantially higher remuneration.”

It is noteworthy that some of these private firms are multinational corporations and financial institutions that have gained entry to the newly liberalized markets of emerging market economies.

To encourage countries to adopt international codes and standards, the Ministry of Finance and Economy of the Republic of Korea (1999) suggests that they be offered some incentives. One possible incentive is to link the participation by emerging economies in the FSF with their adoption of the most essential transparency standards. The G7 seems to follow a hard-line approach. Aside from including the adoption of internationally agreed standards in the IMF/WB conditionality, it has also considered other measures, such as “[M]oves by our regulators to consider a country’s adherence to the range of relevant international standards, including international standards for banking supervision, as part of the prudential criteria used when considering market entry by foreign banks.” (G7 1999a) This will result in asymmetric market access in favor of developed economies.

When it comes to monitoring the adoption of the international standards, Jalan (1999) has emphasized the point that “[I]t is also important that the manner in which these international standards are monitored does not degenerate into categorizing countries as performers and non-performers.”

5. Capital Adequacy Requirements

The Basle Capital Accord of 1988 was designed by the Basle Committee on Banking Supervision (BCBS) to apply to the internationally active bank of its member countries. Within a span of ten years, a number of non-member countries including emerging market economies had adopted the Accord and applied it also to purely domestic-oriented banks.

The 1988 Accord was primarily concerned with minimum capital standards to cover credit risk. This was later revised to also cover market risk. With the rapid development and growing complexity of the international system, the BCBS feels that the bank’s capital ratio calculated using the current Accord may no longer be a good indicator of its financial condition. For developing economies, the relevant issue relates to the incentives which the Accord was capable of providing to short-term interbank lending, a significant element of the volatile capital movements perceived as having contributed to the Asian crisis (Cornford 2000). In June 1999, the BCBS circulated its proposed new capital adequacy framework, which consists of three pillars: minimum capital requirements, supervisory review process, and effective use of market discipline. Given its overriding goal, which is to promote safety and soundness in the international financial system and wide acceptance of the 1988 Accord, the BCBS is therefore right in

saying that “[T]he Accord is a corner stone of the current international financial architecture” (BCBS 1999). Unlike the 1988 Accord, the proposed new Accord was developed with the intention that the guiding principles embodied in the three pillars are generally suitable for any bank in any jurisdiction.

With regard to the first pillar, the BCBS proposal involves two approaches for risk weighting: the standardized approach and the internal ratings-based approach. The latter is more applicable to some sophisticated banks. The former, on the other hand, is much more relevant to developing and emerging market economies. The standardized approach proposes specific risk weightings for sovereigns, banks and corporations. For banks, two alternative options are being offered: risk weighting based on risk weighting of sovereign in which the bank is incorporated and risk weighting based on the assessment of the individual bank. In a nutshell, banks’ capital asset requirements will be linked to external ratings done by international credit rating agencies

The G24 (1999b) has expressed some concerns about the new capital adequacy framework aimed at strengthening the soundness of the global banking system for fear that it could result in more stringent conditions and impede access for developing countries to international capital markets. Indeed, this fear has some empirical basis. In their study using historical data on sovereign and individual borrowers, Ferri *et al.* (2000) found that:

- a. Rating of banks and corporations in developing countries are less common, so capital asset requirements would be practically insensitive to improvements in the quality of assets – widening the gap between banks of equal financial strength in higher- and lower-income countries.
- b. Bank and corporate ratings in developing countries are strongly linked to the sovereign ratings for the country – and appear to be strongly related (asymmetrically) to changes in the sovereign ratings. Thus, capital requirements in developing countries would be exposed to the cyclical swings associated with the revision of ratings.

The authors conclude that the new framework would reduce the credit available to non-high income countries and make it more costly, limiting economic activity. Also, bank capital needs in developing countries would be more volatile than those in high-income countries. Cornford (2000) has reached similar conclusions, but he emphasizes the point that the poor track record of credit rating agencies demonstrates that their

ratings cannot be relied upon for setting risk weights under the standardized approach especially since they tend to reinforce cyclical movements.¹²

6. Highly Leveraged Institutions (HLIs) and Credit Rating Agencies

HLIs' participation in the international financial markets grew tremendously in the 1990s. Being unregulated, their trading practices can have a significant impact on the financial markets of small open economies. It is not therefore surprising that the unregulated HLIs had figured prominently in the debate on the causes of the East Asian financial crisis. During the height of the Asian financial crisis, authorities in crisis-hit countries had pointed out the possible role played by HLIs in triggering and accentuating the reversal of capital flows and, therefore, called for strict regulations of these institutions. Apparently, developed countries did not pay much attention to this complain until LTCM encountered serious difficulties, which could have further destabilized the already volatile international financial markets were it not for the quick rescue organized by the Federal Reserve Bank of New York.¹³ Thus, policy makers in emerging market economies think that HLIs ought to be regulated. The issue, however, is how to regulate HLIs.

ASEAN's (1998) position on this issue is that HLIs should be subject to regular and timely transparency and disclosure requirements. In their study, FSF examined two concerns related to the trading practices of HLIs. These are the potential systemic risks posed by HLI and HLIs' destabilizing impact on the markets of small and medium-sized open economies. Its recommendations, which the G7 intends to promote for implementation, are as follows:

- a. Better risk management by HLIs and their counterparties.
- b. Better disclosure practices by financial institutions, including enhanced disclosure by HLIs and their creditors.
- c. Enhanced regulatory and supervisory oversight by national authorities of financial institutions which provide credit to HLIs.
- d. Enhanced national surveillance of financial market activity in view of concerns about systemic risk and market dynamics caused by HLIs' activities.
- e. Review by leading foreign exchange market participants of existing good practice guidelines for foreign exchange trading and the articulation of model guidelines for possible adoption by market participants in smaller economies.

¹² Refer to related discussion below.

¹³ In his budget message for fiscal year 1999, Prime Minister Mahathir asked: "Can't this be called 'cronysm'? If that had happened in our country, what would they have said about this?"

f. Improved market infrastructure.

It thus appears that ASEAN's position is incorporated in the G7 position as far as the approach towards regulating HLIs is concerned. However, others like Leong (2000) and the UN Task Force (1999) have proposed that minimum prudential standards applied to bank transactions must also be extended to hedge funds. The Ministry of Finance and Economy of the Republic of Korea (1999) has pointed out that one of the lessons from the Asian financial crisis is the need for the financial supervisory authorities of the industrial countries to strengthen their prudential supervision of HLIs and their derivative transactions.

Wahl and Waldo (2000) think that the measures proposed by the FSF will allow HLIs to continue to exert their destabilizing effect on the financial system because:

- derivatives continue to be an opportunity for exorbitant borrowing. Risk funds working with such leverages are not interested in risk management. An improved supervision would not change that because the fast creation of open positions can only be noticed afterwards.
- once more, an international (regulation) problem is shifted to the national level. This stimulates a race between countries for the weakest regulation as a competitive advantage.
- three quarters of all hedge funds are located in offshore centers that lack the political will to implement the recommendations and improve documentation and supervision.

In their view, therefore, only direct regulation of HLIs can stop their potential risk.

The FSF may have anticipated this problem but did not pursue it further at this point. That is why it left the door open to possible direct regulation of HLIs if subsequent reviews found that the recommended measures were not adequately addressing concerns identified.

The other institutions that attracted much attention during the Asian financial crisis are the international credit rating agencies. They seemed to have influenced the decisions of foreign investors in developing economies, but their performance in Asia appeared to be bad. This can be gathered from the large and swift downgrading of crisis-

hit Asian countries they made in a relatively short period.¹⁴ Although credit rating agencies provide information to investors, however, not much is known about the procedures they use in making sovereign ratings. More importantly, “[T]he inclusion of ‘subjective’ elements in their evaluation of sovereign risks has generated a procyclical pattern of risk evaluation, which has tended to promote first excessive investment in developing and transition economies and then huge and abrupt capital outflows” (UN Task Force 1999). Thus, developing countries have called for greater transparency in the rating process of international credit agencies (ASEAN 1998, G24 1999b). In 1999, the APEC Finance Ministers asked Deputies to survey credit rating agencies’ rating methodologies and transparency practices. To date, the G7 has not taken up this issue in its agenda for reforms of the international financial architecture.

7. Private Sector Involvement

Given the huge cross-border movements of predominantly private capital, there is now a widespread international agreement to involve the private sector in crisis prevention and management. This will reduce the moral hazard problem present in previous IMF bail-out programs and the need for IMF to provide large amount of resources to restore stability into a crisis-hit country. The G7 outlined in 1999 a framework for private sector involvement in crisis resolution that involves a broader range of tools (e.g., IMF lending into arrears, standstills, etc.) available to the international community to promote appropriate private sector involvement. It followed it up in 2000 by outlining additional measures (e.g., strong, continuous dialogue between debtors and their private creditors, collective action clauses to be encouraged by the IMF, etc.) to be implemented to move the process farther. The IMF (2000c) has noted two recent cases of successful private sector involvement through the restructuring of international sovereign bonds.

Developing countries want a step further by proposing to amend Article VIII, Section 2(b) of the Articles of Agreement to allow the Fund to sanction a temporary stay on creditor litigation in extreme situations to facilitate orderly debt restructurings (G24 1999a). The UN Task Force (1999) argues that IMF’s sanctioning of standstill can reduce moral hazard problem on the part of borrowers and, if combined with the Fund’s lending into arrears, can give a crisis-hit country some breathing space while in the

¹⁴ Thailand was downgraded four notches by both Moody’s and Standard and Poor’s between July 1997 and the early 1998; Indonesia five notches by Moody’s and six by Standard and Poor’s between June 1997 and early 1998; and Republic of Korea six notches by Moody’s and no less than 10 by Standard and Poor’s during the same period (Cornford 2000).

process of negotiating with its creditors. It also proposes an alternative, which is for the debtor country to declare a standstill unilaterally, but it must submit it for approval within a specified period to an independent panel, whose sanction will give it legitimacy. For the G7, standstills must be done in conjunction with the IMF's support for the debtor countries' policies and programs. Still, another approach is to organize an *ad hoc* representative committee for debt workout as proposed by the Ministry of Finance and Economy of the Republic of Korea (1999). This pre-arranged mechanism, which consists of representatives from debtor and creditor governments, central banks of most G7 countries, the IMF and other relevant organizations, can be activated when needed and could recommend an automatic rollover of liabilities that would mature within the three months of IMF assistance.

Given the various options for "bailing-in" the private sector, the IMF (2000c) stresses the point that the precise form will have to be decided on a case- by-case basis.

8. The Bretton Woods Institutions

Despite calls from some quarters to abolish the IMF (e.g., Chari and Kehoe 1998) or reduce its role, there is widespread consensus among developed and developing countries to reform the institution so that it can play a key role in crisis prevention and resolution in this era of high mobility of international capital. Such consensus is well reflected in the key principles for reform of the IMF contained in the report from the G7 Finance Ministers to the Heads of State and Government last 8 July 2000 in Fukuoka, Japan (see **Annex D**). There is an agreement not only on the need to increase IMF's resources so that it can readily deal with the threat of stability of the international financial system, but also on the need to improve its capacity to act as an international lender of last resort. This was done recently with the establishment of the New Arrangements to Borrow in 1997 and the 45 percent quota increase in January 1999, and the opening of the Supplemental Reserve Facility (SRF) in December 1997 and the Contingent Credit Line (CCL) in April 1999. There is also agreement on the need to do some "housecleaning" and "renovation" of IMF's facilities, which includes the finetuning of the recently opened CCL so that it can be "more attractive and operational for potential candidates" (Suarez 2000).¹⁵

¹⁵ In their report to the Heads of State and Government on 8 July 2000, the G7 Finance Ministers went as far as proposing to abolish the commitment fee, reduce the initial rate of charge and introduce greater automaticity of the CCL.

Viewed from a historical perspective, the IMF now seems to have a much larger role and more comprehensive mandate in managing the international financial system than before. To be effective in carrying its mandate, the IMF's legitimacy must be well secured.¹⁶ The G7's approach to this issue is to strengthen the governance and accountability of the IMF. For instance, the Interim Committee of the Board of Governors on the International Monetary System was transformed in September 1999 into a permanent committee called International Monetary and Financial Committee and strengthened its role as the advisory committee of the Board of Governors. There is now an explicit provision for preparatory meetings of representatives of Committee members (deputies). A permanent independent evaluation office inside the IMF has been established and is about to be made operational this year. The IMF is being encouraged to make its documents public.

While developing countries welcome such reforms, however, they want greater participation in the decision-making process at the Fund, especially since many of the decisions to be made by the Boards and Committees will have a huge impact on their economies. More specifically, they want to have greater representation in the Boards with larger voting power so that "the institution's activities better reflect the views of the emerging market economies rather than the existing 'Washington' consensus" (Leong 2000). As Jalan (1999) has observed, "It is the ironies of the last forty years that although developing countries, as a group, have grown much faster than the developed countries over this period and their relative economic strength in terms of output and trade has increased substantially, their actual voting power in Bretton Woods institutions has tended to decline!" The present allocation of quotas and voting shares also does not take into account the fact that Japan's economic power has grown fast in the last forty years. Japan is a key player in East Asian economies and can help represent their interests in this institution. Thus, changes in the determination of quotas and voting shares to reflect the economic realities of member countries, particularly emerging East Asian countries and Japan, will give them a more powerful voice in the IMF Boards.

Relatedly, some important decisions specified in the IMF Articles of Agreement require either 70 percent or 85 percent of the total voting power; other decisions are made by a majority of the votes cast. The US, which currently has about 17 percent of the total voting power, can have effective veto power over major decisions of the Fund's body.

"Enhancing transparency" is one of the phrases that have figured prominently in the debate on reforming the international financial architecture. For example, the report

¹⁶ Porter (2000) defines legitimacy as "the acceptance of the existence of power or of a set of social relationships because it is believed that these are based on a justifiable set of rules." (p. 2).

of G7 Finance Ministers to the Koln Economic Summit mentioned the IMF's Code of Good Practices on Fiscal Transparency, the draft Code of Good Practices on Transparency in Monetary and Financial Policies and a number of measures to increase transparency in the Fund's member countries' policies as well as its own operations. Mention was also made of the improvement of the transparency of IMF's actions and decisions. However, there is no mention about enhancing the transparency in the selection of the heads of the Bretton Woods institutions. There seems to be an informal agreement between the US and European countries that the President of the World Bank must be an American and the Managing Director of the IMF a European. In this regard, the G24 (2000) has urged "the Executive Boards of the BWIs to design a process for the selection of the Managing Director of the IMF and the President of the World Bank that is transparent, involves the entire membership through the Executive Boards, and allows the selection of the best candidate from any part of the world."

The inadequate representation of developing economies in the Boards of BWIs, the effective veto power of the US and the lack of transparency in the selection of the heads of BWIs all can undermine the legitimacy of these institutions worldwide. Developing economies are battling for the inclusion of these issues in the agenda for reforming BWIs and other key institutions in the international financial architecture.

9. Regional Financial Arrangement

The idea of having an Asian regional financial arrangement was inspired by the recent Asian crisis. First, it demonstrated that Asian countries can quickly raise resources within the region to assist a neighboring country in containing a crisis. Second, unlike previous crises, the recent crisis was highly contagious and was aggravated further by herd behavior of investors. This needs regional cooperation. Third, it took the IMF some time to fully understand the nature of the crisis under a regime of high capital mobility, as can be gathered from its strict conditionalities applied to countries encountering current account imbalances, and when it finally did understand, it was found not ready to provide the required resources to contain the crisis. Fourth, it clearly demonstrated the need for tighter surveillance of individual countries and the region as a whole and for developing an early warning system for the region, which could not be adequately provided by an international institution that has a global mandate. Fifth, it took developed countries a long time to appreciate the global implications of the Asian crisis until other large developing countries much closer to their attention or interest began to feel the adverse effects of the Asian crisis.

The original idea of a self-help regional financial arrangement (RFA), which became popularly called as the Asian Monetary Fund (AMF), was proposed by Japan in August 1997. The resources that could be mobilized from Asian countries could be pooled together and can be used as a regional lender of last resort. This proposal was strongly opposed by the US and European countries because it could undermine the discipline imposed by the IMF and might pose serious moral hazard problem (Sakakibara 2000). China opposed it because of Japan's leadership in that effort (Goad 2000). But what was lost in the debate is the idea that, given the growing complexity of the global financial system, the international financial architecture could include a regional financial arrangement that will complement the role of an international financial institution. To borrow a metaphor, the task of strengthening the international financial architecture does not only require that the old edifice be repaired but that a new one should be added. Thus, the East Asian challenge brings home the point that building a regional financial arrangement is essentially part and parcel of the current effort to strengthen the international financial architecture. It implies that the regional financial arrangement must be designed in such a way that it can play a complementary role to the existing international financial architecture and contribute to the stability of the world financial system (Wang 1999, UN Task Force 1999).

Since then, other variants of the proposed regional financial arrangement were put forward that attempted to address the concerns mentioned above. Shinohara (1999) recommends the establishment of the Asian Monetary Fund (AMF) with the following functions: promoting policy dialogue, providing a mechanism for emergency support, and crisis prevention. Leong (2000) supports the proposal of establishing a stabilization fund like the AMF with a standby regional financial support mechanism to provide liquidity quickly to "hot spots" within the East Asian region to ward off speculative currency attacks. The APF (2000) proposes a RFA that would provide a *lender of last resort facility* together with the implementation of an *effective surveillance system* over Asian economies and *complement* the activities of the IMF through close collaboration with each other. The features of the APF's proposed RFA are:

- a. a sufficient quantity of international liquidity to forestall a currency crisis should be prepared and, if needed, provided;
- b. upon satisfying surveillance criteria (e.g., macroeconomic policy, bank regulation and prudential measures and international capital movements), access to the facility is immediately made available for the requesting economy; and
- c. a new structure of "conditionalities" which could focus on strengthening the financial sector should be considered that correspond appropriately to new capital-account crises and carefully integrated

with regional surveillance procedures that monitor key indicators related to capital account crises.

While Shinohara (1999) and Leong (2000) support the idea of having a permanent institution for the RFA, the APF prefers to have a minimalist institutional structure with very focused mandate so as not to duplicate the functions of an international lender of last resort. Wang (1999) brought up some possible contractual arrangements, such as regional arrangements to borrow and bilateral swap arrangement, which do not necessarily need a permanent institution.

Given the political and economic realities in the region, ASEAN has been slowly building up the infrastructure for a regional financial arrangement in the region to supplement the existing international facilities. The Chiang Mai Initiative launched in May 2000 is a significant step in the right direction. The ASEAN+3 (i.e., Japan, China and Korea) have agreed to strengthen regional surveillance in East Asia and expand the ASEAN Swap Arrangement that would include the ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among them (ASEAN+3 2000).

The attitude of the developed economies and the international community towards the establishment of a regional financial cooperation has changed recently. For instance, the latest report of the G7 Finance Ministers to the Heads of Government and State (2000b) includes a section at the end on regional cooperation, stating that:

“Regional cooperation through more intensified surveillance can help contribute to financial stability by strengthening the policy framework at the national level. Cooperative financing arrangements at the regional level designed to supplement resources provided by the IFIs in support of IMF programs can be effective in crisis prevention and resolution.”

Mr. Kohler, the recently appointed Managing Director of the IMF, expressed the same view. He said that:

“Regional initiatives can be very helpful in supporting sustained economic growth and stable financial relations among participating countries – which are precisely the goals that the IMF is tasked to promote, on a global scale, through its surveillance and financing responsibilities.”
(IMF 2000d)

Obviously, these views are significantly different from their previous views when the idea of establishing a self-help regional financial arrangement aimed at preventing

and quickly resolving a liquidity crisis was first brought up by Japan. It seems that a regional financial arrangement is now gaining wide acceptance in the international community as part of the effort to fix the international financial architecture and achieve a more balanced globalization.

IV. GENERAL ASSESSMENT

The call of the G7 leaders to reform the international financial architecture at the Halifax Summit meeting in 1995 in the wake of the Mexican crisis has inspired the international community to think about how to fix the system. It turned out that the Mexican crisis was just a prelude to a much larger crisis that struck emerging market economies in Asia and brought home the point that under increasing globalization of trade and finance, a financial crisis of an emerging market economy can easily spread to other financial markets in the region, and can eventually affect the stability of the financial markets in developed economies. This episode has made the reform of the international financial architecture more urgent to avoid similar crisis to reoccur in Asia or other regions of the world. East Asia, armed with a wealth of experience in managing a capital account crisis, can contribute a lot to the debates on issues related to the strengthening of the international financial architecture.

Reform of the international financial architecture is currently underway. We owe it to the international community for quickly reaching consensus on a number of issues and immediately putting them in place. However, there are still a lot of issues that have remained unresolved, and developed and developing economies hold divergent views on many of these issues. From the perspective of East Asia and developing economies, the glass is still half full, and the discussions taking place within G7 and G7-led “virtual” institutions are unlikely to fill up the glass. The following assessment on East Asia’s and developing economies’ views on issues regarding the governance structure for reforming the international financial architecture, the substantive aspects of the reform and the regional financial arrangement will help clarify this point.

1. Governance Structure

This refers to both the governance structure for reforming the international financial architecture and the BWIs. As many historians had pointed out, there were only two persons actively participating in the formulation of the original Bretton Woods system. This is understandable since most developed economies were weakened by the war and were very much preoccupied with reconstruction. Developing economies, on the

other hand, were just starting to shake off their colonial dust and had not yet fully comprehended the implications of establishing the Bretton Woods system.

The situation today is entirely different. Emerging market economies are now exerting influence in the global markets. As the last Asian crisis clearly demonstrates, financial instabilities in emerging market economies can affect the financial markets in developed economies, and financial policies in developed economies can likewise affect the stability of the financial markets in emerging market economies.

There is widespread international consensus on the need for developing and emerging market economies to participate in discussions on reforming the international financial architecture. Finance Minister Paul Martin of Canada, the first Chairman of the G20, clearly articulates this view:

“Experience with international development programs has shown that even the most well-intentioned programs are likely to fail unless the countries involved are given ‘ownership’ of their development agenda. The same reasoning applies to reform of the international financial architecture. Best practices will not be implemented, and standards and codes will not be observed, if the countries that must adopt them have not had a ‘voice’ in their development. That is why the G-20 is so important – because it brings key emerging market countries to the table with the G-7 countries.” (Martin 2000b, underscoring added).

Although the G20 is a significant improvement over having only G7 dominating the debates and exerting great influence on the form and content of the reforms to strengthen the international financial architecture, still it is a far cry from what developing economies deserve, especially since most of the recent advances in reforming the international financial architecture pertain to the adoption of international standards, codes and best practices. The G7’s strong hand in the selection of *key emerging economies* in the G20 could ensure their continued control over the agenda for discussions. The results of the first meeting of the G20 already provide a clue to this. For instance, the future of the IMF was discussed only peripherally during the first meeting of the G20 (The Times of India 1999). Also, the agenda focused too much on improving sound domestic policies to reduce vulnerabilities facing the members’ economies and less on thorny issues that aggravate such vulnerability, such as the regulation of hedge funds and improving transparency of international credit rating agencies.

Since the chairmanship of the G20 will be rotated first among the G7 countries, it will only be after fourteen years that a participant from *key emerging market economies* will become the chair. This period could be much longer than Keynes' time horizon when he said that in the long-run, we will all be dead. The main issue raised by critics against the G20 is well represented in Kirton's (1999) comments:

“There are thus concerns about whether this fledgling Group constitutes a sufficient degree and form of institutionalized association with the G7. One doubt arises from the view of some who see the G20 as part of the ‘G7-ization’ of the world. In this view, the G20 was born to legitimize G7 initiatives to the wider world, by securing a broader consensus for G7-generated ideas. The G20’s eleven non-G7 members are thus destined to affect issues merely on the margin, to be informed of G7 initiatives, and to be given some semblance of participation. The G20 underscores the fact that the G7 does not want to leave the reform of the international financial system to the IMF or World Bank, where developing countries have an institutionalized role.”

There are substantial benefits to increasing the effective participation of developing and emerging market economies in international “virtual” institutions and in BWIs. If we go over the substance of the debates over the last two and half years, the concerns originally expressed by developing and emerging market economies on reforming the international financial architecture have slowly crept into the agenda of the G7. The crisis East Asian economies recently underwent has enriched their experience in dealing and preventing a crisis. Their effective participation in international “virtual” institutions and in the BWIs can surely improve the quality of the dialogue and help accelerate the process of arriving at a consensus on certain issues related to the strengthening of the international financial architecture. And key to this is not only greater participation but developing a credible process for selecting representatives to the “virtual” institutions and changing the determination of quotas and voting shares at BWIs to enhance developing countries' effective voice in these institutions.

In brief, East Asia's and developing economies' concern regarding the governance structure for the reform of the international architecture and the governance structure of BWIs deserve to be given utmost attention in discussions on reforming the international financial architecture.

2. Substance of the Reform Agenda

Strengthening the international financial structure requires domestic reforms, reforms of the rules that govern cross-border transactions and reforms of the international institutions that oversee and enforce the rules. The issues discussed in the preceding section cover these three areas for reform. As noted, there is a fairly wide divergence of views between developing and emerging market views and the developed economies' views on several key issues. The latter tend to focus on measures aimed at strengthening the domestic financial markets; hence, the emphasis on enhanced transparency, provision of timely and accurate information, improved corporate governance, adopting international standards and codes, etc. These are all important issues especially for developing and emerging market economies so that they can strengthen their domestic financial systems and thereby reduce vulnerabilities to both external and internal shocks. In fact, the recommendations of the FSF are keyed mainly towards developing and emerging economies.

There is, however, a limit as to how much developing and emerging market economies can do to reduce vulnerabilities of their financial markets. To paraphrase Wahl and Waldo (2000), one can build a dam to protect himself from the flood; but if the flood water continues to rise, then there is no way he can protect himself from the flood. This is the scenario that one can get from the proposals that came from the FSF that tend to shift the responsibility of strengthening the international financial architecture to the national level. The international community must not lose sight of the need to find ways to improve the rules covering cross-border transactions and to reform the IMF. For East Asia, apart from choosing the appropriate exchange rate, issues like the stability of the three major currencies, regulation of hedge funds, increased transparency of credit rating agencies, capital controls, reform of the IMF, etc., all deserve to be given their due importance in the discussions regarding the strengthening of the international financial architecture.

3. Regional Financial Arrangement

The proposed regional financial arrangement is a home-grown proposal of East Asia that can substantially change the international financial architecture. As Bergsten noted (2000), “[I]t could alter the international financial, trade, and economic architecture more fundamentally than any of the current deliberations in the International Monetary Fund, the World Trade Organization and the G7.” Thus, the proposed regional financial arrangement should be discussed not only in the context of East Asia’s desire to develop

a regional mechanism to forestall a financial crisis in the region but also in the context of strengthening the global financial system.

The next challenge for East Asia is how to work out the details of the regional financial arrangement so that it can meet its objectives. Even the ASEAN+3 Chiang Mai Initiative is still short on this. Some of the clues are provided in the APF report, but they also lack some details. Thus, this issue needs to be thoroughly discussed further.

The other challenge is whether the Asian regional financial arrangement could later on take on additional roles, such as assuming the BIS role for Asia and providing and maintaining a clearing system for Asia (Shinohara 1999) and a spring board for developing an Asian currency as proposed by the Philippines and Hong Kong. The UN Task Force (1999) takes a view that if regional institutions, like the one envisioned for Asia, are strengthened, then the “IMF could be visualized as part of a network of regional reserve funds, and its operation could then concentrate on relations with these reserve funds rather than on support to specific countries.” Bergsten offers almost the same view. All this only serves to underscore the need to discuss this issue at the international level.

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**Table 1. REAL GDP GROWTH RATES OF EAST ASIAN ECONOMIES,
1996-2001 (In %)**

Countries	1996	1997	1998	1999	2000	2001
<u>Northeast Asia:</u>						
China	9.6	8.8	7.8	7.1	7.3	7.6
Hong Kong, China	4.6	5.0	-5.1	2.9	6.8	4.7
Japan	5.1	1.6	-2.5	0.3	1.2	2.1
Korea	6.8	5.0	-5.8	10.7	8.5	5.9
Chinese Taipei	6.1	6.7	4.6	5.7	6.3	6.8
<u>Southeast Asia:</u>						
Brunei Durussalam	3.5	4.0	1.0	2.5	n.a.	n.a.
Indonesia	7.8	4.9	-13.7	0.2	4.2	4.5
Malaysia	10.0	7.5	-7.5	5.4	6.0	6.2
Philippines	5.8	5.2	-0.5	3.2	3.9	4.1
Singapore	7.5	8.4	0.4	5.4	6.5	5.5
Thailand	5.9	-1.8	-10.4	4.1	4.4	4.5
Vietnam	9.3	8.2	5.8	4.8	4.5	5.3

Note: Figures for 1996 to 1999 were taken from APEC Economic Outlook 2000 (July 2000 draft report). Figures for 2000 to 2001 were obtained from PECC, Pacific Economic Outlook, 2000 – 2001 (2000).

Table 2. INCREASES IN CPI OF EAST ASIAN ECONOMIES, 1996-2001

Countries	1996	1997	1998	1999	2000	2001
<u>Northeast Asia:</u>						
China	8.3	2.8	-0.8	-1.4	0.5	1.5
Hong Kong, China	6.3	5.8	2.8	-4.0	-2.2	3.2
Japan	0.1	1.8	0.6	-0.3	-0.4	-0.1
Korea	5.0	4.4	7.5	0.8	2.8	3.2
Chinese Taipei	3.1	0.9	1.7	0.2	2.2	2.5
<u>Southeast Asia:</u>						
Brunei Darussalam	2.0	1.7	-0.4	-0.1	n.a.	n.a.
Indonesia	6.5	10.3	77.6	8.7	8.5	6.0
Malaysia	3.5	2.7	5.3	2.8	2.8	3.2
Philippines	9.1	5.9	9.8	6.6	6.0	6.5
Singapore	1.4	2.0	-0.3	0.0	1.5	2.0
Thailand	5.9	5.6	8.1	0.3	2.0	3.0
Vietnam	4.5	3.6	9.2	0.0	7.5	9.5

Note: Figures for 1996 to 1999 were taken from APEC Economic Outlook 2000 (July 2000 draft report). Figures for 2000 to 2001 were obtained from PECC, Pacific Economic Outlook, 2000 – 2001 (2000).

Table 3
Fiscal Balance as % of GDP

Year	Indonesia	Rep. of Korea	Malaysia	Philippines	Thailand
1996	1.2	0.0	1.1	-0.6	1.0
1997	-0.7	-1.7	2.4	-0.8	-1.7
1998	-1.9	-4.4	-1.5	-2.7	-2.9
1999	-2.3	-3.5	-3.5	-4.4	-3.7

Source: Asia Recovery Information Center, ADB (2000).

Table 4. Selected Financial Market Indicators
(% change from end-December 1999 to 5 July 2000)

Countries	Exchange Rates	Stock Market Indices	Overnight Interbank Rates
Indonesia	-23	-24	0.3
Rep. of Korea	2	-19	0.35
Malaysia	0	0.4	0.01
Philippines	-8	-28	1.3
Singapore	-4	-16	n.a.
Thailand	-5	-34	2.5

Source: Asia Recovery Information Center, ADB (2000).

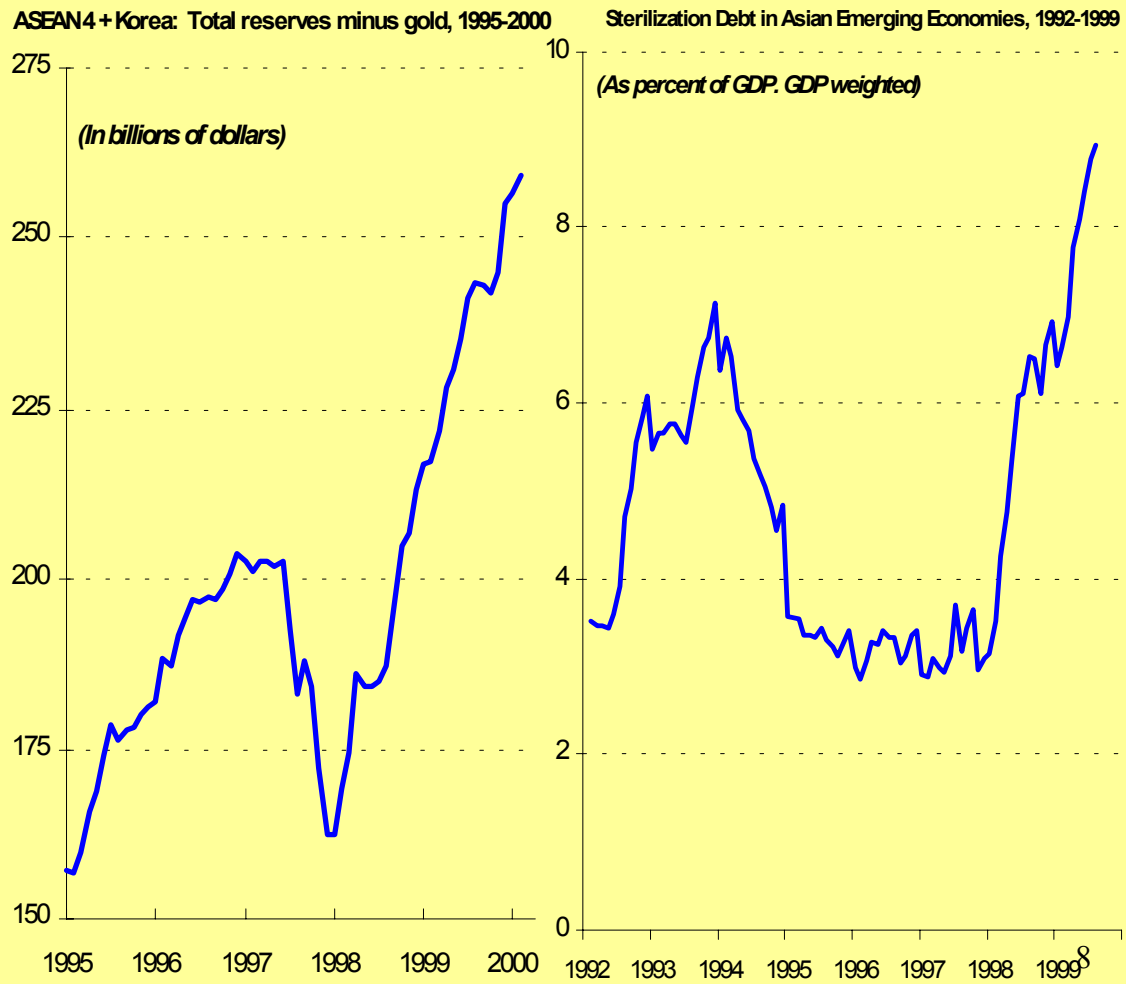
Table 5. Members of G7- Led Institutions and G22

G-7	G-20	Financial Stability Forum	G-22
<p><u>Members:</u></p> <ol style="list-style-type: none"> 1. Britain 2. Canada 3. France 4. Germany 5. Italy 6. Japan 7. United States 	<p><u>Members:</u></p> <ol style="list-style-type: none"> 1. Argentina 2. Australia 3. Brazil 4. Canada (chair) 5. China 6. France 7. Germany 8. India 9. Indonesia 10. Italy 11. Japan 12. Korea 13. Mexico 14. Russia 15. Saudi Arabia 16. South Africa 17. Turkey 18. United Kingdom 19. United States 20. European Union 	<p><u>Members: (40)</u></p> <ol style="list-style-type: none"> 1. Chairman (1) 2. National Authorities (25) - three from each of the G-7 countries (treasury, central bank, and supervisory agency), and one from Australia, Hong Kong, Netherlands and Singapore. 3. International Financial Institutions (6) -IMF (2), WB (2), BIS (1), and OECD (1) 4. International Regulatory and Supervisory Groupings - <i>Basel Committee on Banking Supervision</i> (2); <i>International Organization of Securities Commissions</i> (2); and <i>International Association of Insurance Supervisors</i> (2) 5. Committee of Central Bank Experts (2) - Committee on the Global Financial System (1) and Committee on Payments and Settlement Systems (1) 	<p><u>Members:</u></p> <ol style="list-style-type: none"> 1. Britain 2. Canada 3. France 4. Germany 5. Italy 6. Japan 7. United States 8. Russia 8. Argentina 9. Australia 10. Brazil 11. China 12. Hong Kong 13. India 14. Indonesia 15. Malaysia 16. Mexico 17. Poland 18. Singapore 19. South Africa 20. South Korea 21. Thailand
<p><u>First Meeting:</u> Nov. 1975</p>	<p><u>First Meeting:</u> December 1999</p>	<p><u>First Meeting:</u> April 1999</p>	<p><u>First Meeting:</u> Feb. 1988</p>

Note: Finance Ministers and Central Bank Governors of the G-20 member countries attended the first meeting held on December 15 & 16, 1999 in Berlin, Germany. The heads of IMF, WB and the Development Committee of the IMF and WB also attended the meeting.

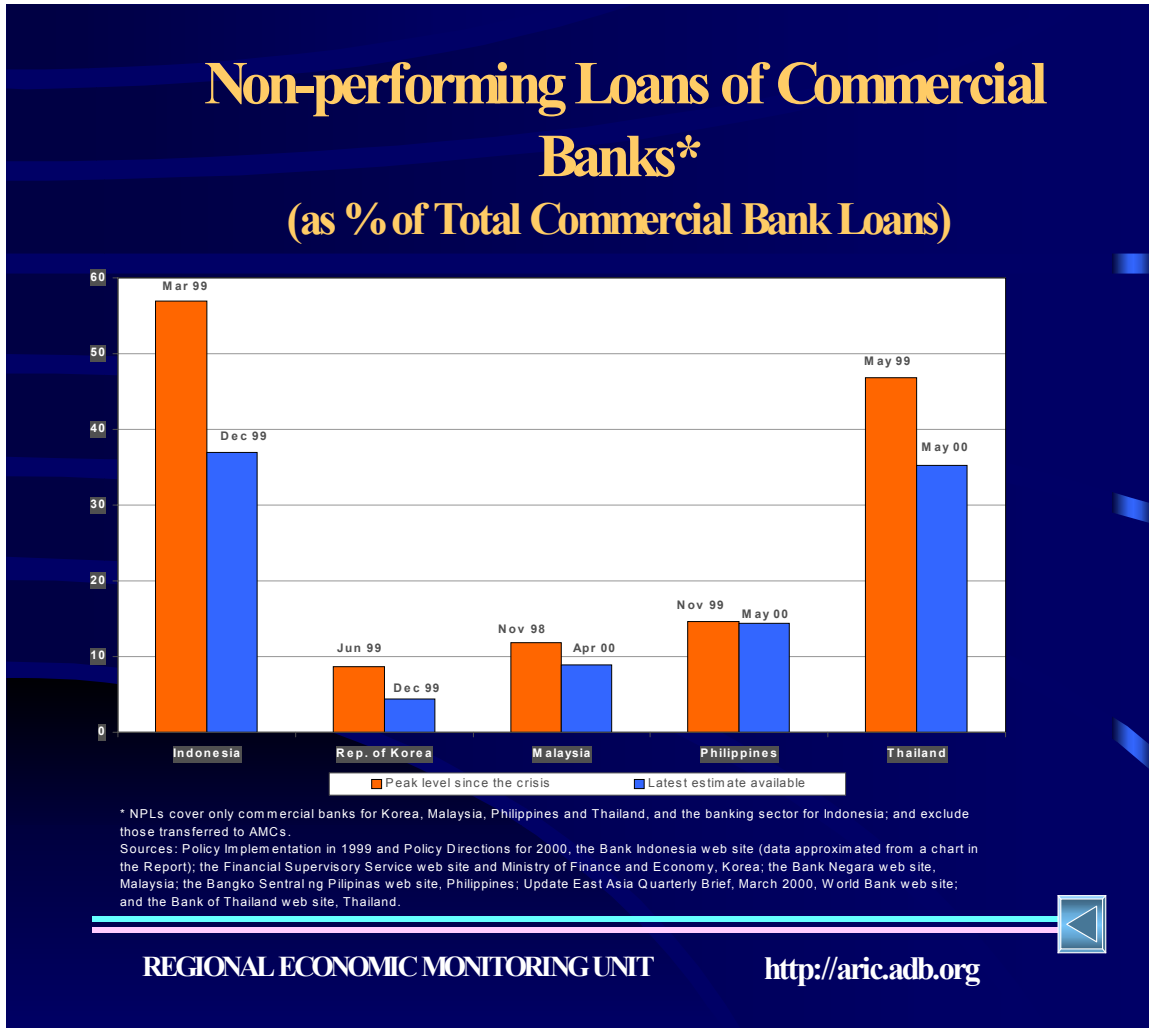
Figure 1

Macro policy regime - sustainability



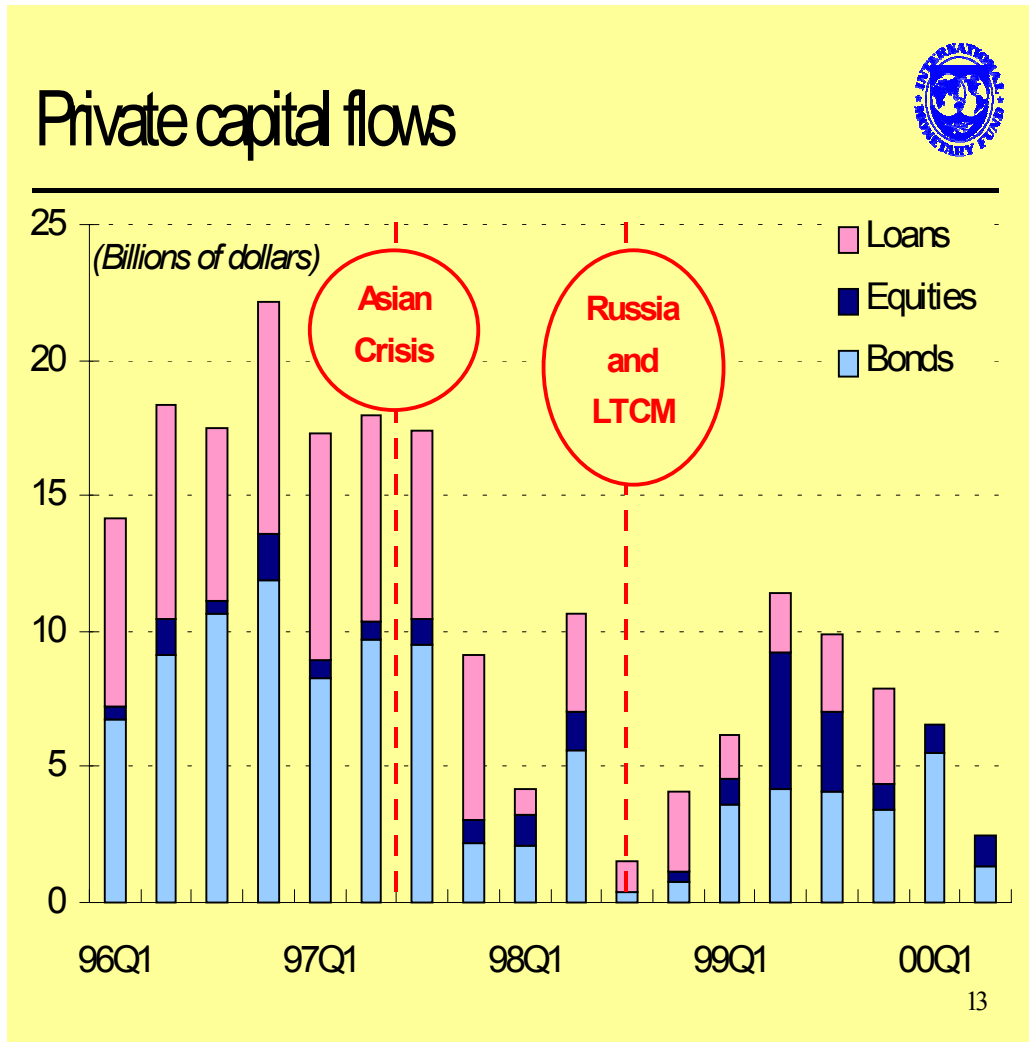
Source: David C. L. Nellor (2000).

Figure 2



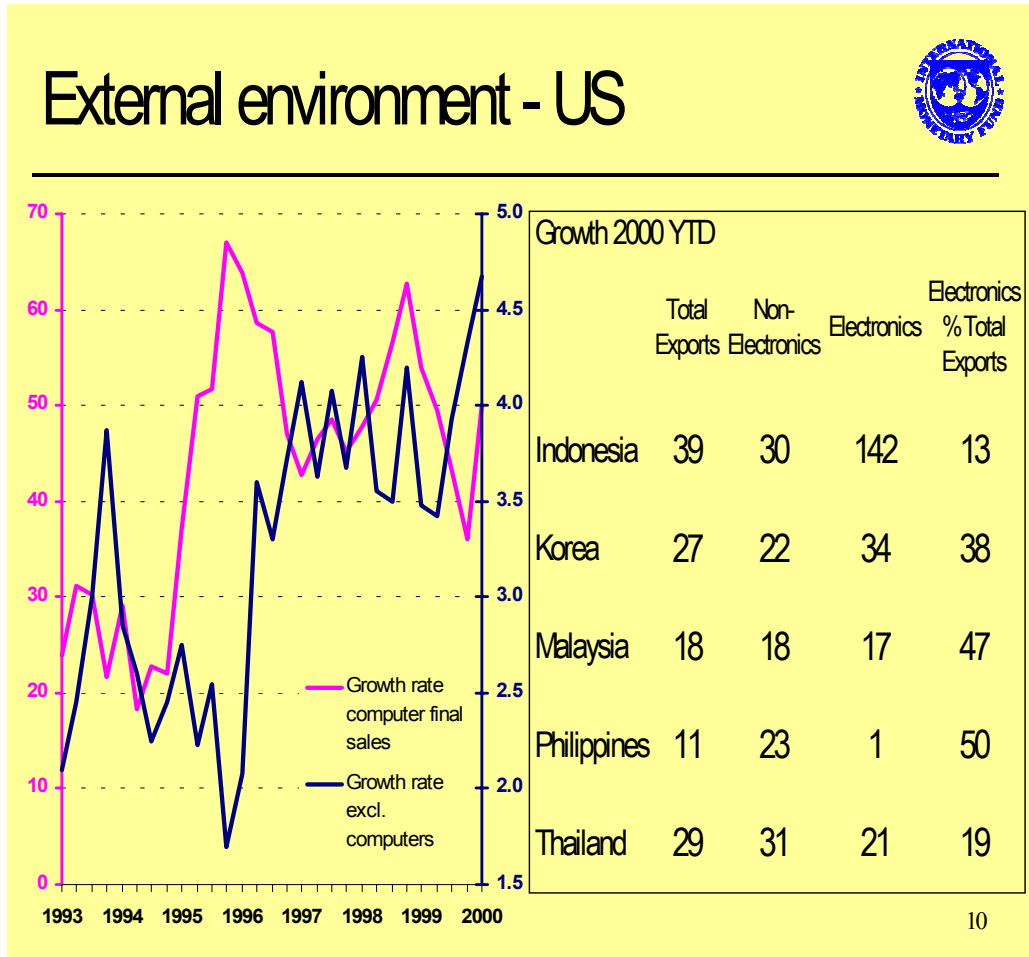
Source: Asia Recovery Information Center, ADB (2000).

Figure 3



Source: David C.L. Nellor (2000).

Figure 4



Source: David C. L. Nellor (2000).

G-22 REPORTS ON THE INTERNATIONAL FINANCIAL ARCHITECTURE

In response to the crisis in Asia, Finance Ministers and Central Bank Governors from a number of systemically significant economies met in Washington, D.C. in April 1998 to examine issues related to the stability of the international financial system and the effective functioning of global capital markets¹⁷. In their discussions, Ministers and Governors stressed the importance of strengthening the international financial system through action in three key areas: enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises.

Three working groups were formed to contribute to the international dialogue on how to proceed in these key areas. A strength of these working groups was the diversity of their participants and the openness of their consultation process. Each working group comprised representatives from finance ministries and central banks of developed and emerging market economies; international organizations were invited to participate in the discussions; and contributions and views from other international groups, countries not represented in the working groups, and private sector representatives were sought.

The three working groups have prepared reports on the outcome of their discussions and recommended a range of actions to strengthen the international financial system.

Enhancing Transparency and Accountability

The Working Group on Transparency and Accountability considered the contributions that transparency and accountability can make to improvements in economic performance, as well as the nature of information needed for effective transparency and accountability¹⁸. Members attached particular importance to enhancing the relevance, reliability, comparability and understandability of information disclosed by the private sector. They recommended that priority be given to compliance with and enforcement of high-quality accounting standards.

¹⁷ The April meeting was attended by Finance Ministers and Central Bank Governors from Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom and the United States. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, attended as observers.

¹⁸ Representatives of the following economies contributed to the Working Group on Transparency and Accountability: Argentina, Australia, Brazil, Canada, France, Germany, Hong Kong SAR (co-chair), Japan, Malaysia, Thailand, the United Kingdom (co-chair), and the United States.

There was consensus on the need to improve the coverage, frequency and timeliness with which data on foreign exchange reserves, external debt and financial sector soundness are published. Furthermore, members recommended that consideration be given to compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors.

Transparency is an important means of enhancing the performance and public accountability of international financial institutions. Members recommended that international financial institutions adopt a presumption in favor of the release of information, except where release might compromise a well-defined need for confidentiality.

Members emphasized the importance of there being transparency about transparency. Members recommended that the IMF prepare a Transparency Report summarizing the extent to which an economy meets internationally recognized disclosure standards.

Strengthening Financial Systems

The Working Group on Strengthening Financial Systems sought consensus on principles and policies that foster the development of a stable, efficient financial system¹⁹. Members identified several areas – corporate governance, risk management (including liquidity management) and safety net arrangements – where standards for sound practices need to be enhanced or developed. The report outlines elements that such standards might contain and suggests ways forward.

Members emphasized that the implementation of sound practices is best fostered through market-based incentives backed by official sector actions. The report sets out a number of concrete actions to promote implementation.

Members recognized that cooperation and coordination among national supervisors and regulators and international groups and organizations are crucial to the strengthening of domestic financial systems. The report sets out several options for enhancing international cooperation: for example, the establishment of a Financial Sector Policy Forum that would meet periodically to discuss financial sector issues.

Managing International Financial Crises

The Working Group on International Financial Crises examined policies that could help to prevent international financial crises and facilitate the orderly and cooperative

¹⁹ Representatives of the following economies contributed to the Working Group on Strengthening Financial Systems: Argentina (co-chair), Brazil, Canada, China, France, Germany, India, Italy (co-chair), Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Sweden, Thailand, the United Kingdom and the United States.

resolution of crises that may occur in the future²⁰. The report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets.

Members stressed the need to encourage better management of risk by the private and public sectors, and recommended that governments limit the scope and clarify the design of guarantees that they offer.

Effective insolvency and debtor-creditor regimes were identified as important means of limiting financial crises and facilitating rapid and orderly workouts from excessive indebtedness. The report outlines the key principles and features of such regimes.

Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. Unilateral suspensions of debt payments are inherently disruptive. The report sets out a framework to promote the collective interest of debtors and creditors in cooperative and orderly debt workouts, and principles that could guide the resolution of future international financial crises.

Source: G22 Reports on the International Financial Architecture, October 1998.

²⁰ Representatives of the following economies contributed to the Working Group on International Financial Crises: Argentina, Australia, Belgium, Brazil, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Korea, Mexico (co-chair), the Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States (co-chair).

Annex B

Objectives and Membership of the Financial Stability Forum (FSF)

The objectives of the FSF are:

- to assess vulnerabilities affecting the international financial system;
- to identify and oversee action needed to address these vulnerabilities; and
- to improve co-ordination and information exchange among the various authorities responsible for financial stability.

In developing priorities and programmes for action to achieve its objectives, the Forum will work through its members.

In general, the **criteria for selecting issues** for the forum's consideration are:

- to give impetus to work on issues that cut across the mandates and expertise of Forum members;
- to co-ordinate work among Forum members, drawing on their comparative advantages;
- to evaluate the completeness of and fill gaps in the body of work among Forum members;
- to endorse work by Forum members that would benefit from such endorsement; and
- to monitor, where appropriate, implementation and any follow-up in areas where policy recommendations have been issued.

The FSF will meet twice a year or as often as needed to carry out its functions.

The FSF has a total of 40 members. The structure of the membership is as follows:

Chairman (1)

National authorities (25)

(three from each of the G7 countries; from the treasury, central bank, and supervisory agency)

- Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, United Kingdom, United States

International Financial Institutions (6)

- International Monetary Fund (2)
 - World Bank (2)
 - Bank for International Settlements (1)
 - Organisation for Economic Co-operation and Development (1)

International Regulatory and Supervisory Groupings (6)

- Basel Committee on Banking Supervision (2)
- International Organization of Securities Commissions (2)
- International Association of Insurance Supervisors (2)

Committees of Central Bank Experts (2)

- Committee on the Global Financial System (1)
- Committee on Payment and Settlement Systems (1)

Source: Financial Stability Forum, 27 September 1999.

Annex C

TASKS OF THE WORKING GROUPS OF THE FINANCIAL STABILITY FORUM

Working Group	Chairman	Terms of Reference	Approach	Progress
Working Group on Highly-Leveraged Institutions	Mr. Howard Davies, Chairman of the UK Financial Services Authority	To recommend actions to reduce the destabilizing potential of institutions employing a high degree of leverage (HLIs) in the financial markets of developed and developing countries.	The Group focused on the potential risk to the financial system presented by the failure of large HLIs and the effects of the activities of HLIs on the dynamics and integrity of financial markets in small and medium-sized economies	The Group submitted its report to the FSF in March 2000. The FSF welcomed the report and endorsed its recommendations.
Working Group on Capital Flows	Mr. Mario Draghi, Director General of the Italian Treasury	To evaluate measures in borrower and creditor countries that could reduce the volatility of capital flows and the risks to financial systems of excessive short-term external indebtedness	The Group adopted a risk management framework, emphasizing the resulting stocks and liabilities of cross-border capital flows and the risk management problems that need to be addressed if the potential benefits of capital flows are to be realized.	The Group submitted its report to the FSF in March 2000. The FSF welcomed the report and endorsed its recommendations.
Working Group on Offshore Financial Centres	Mr. John Palmer, Superintendent of Financial Institutions, Canada	To consider the significance of offshore financial centers for global financial stability.	The Group reviewed the uses and activities of OFCs with a view to addressing problems created by OFCs with weaknesses in financial supervision, cross-border co-operation, and transparency that allow financial market participants to engage in regulatory arbitrage of several forms.	The Group submitted its report to the FSF in March 2000. The FSF welcomed the report and endorsed its recommendations.
Task Force on Implementation of Standards	Mr. Andrew Sheng, Chairman of the Hong Kong Securities and Futures Commission	To explore issues related to and consider a strategy for fostering the implementation of international standards for strengthening financial systems.	The Task Force emphasized the importance of promoting country ownership, providing market and official incentives, and mobilizing resources through enhanced partnerships, as key factors for fostering implementation of standards.	The Task Force submitted its report to the FSF in March 2000. The FSF welcomed the report and endorsed its main thrusts, including 12 key standards identified by the Task Force as being most relevant for strengthening financial systems.
Study Group on Deposit Insurance	Mr. Jean Pierre Sabourin, President of the Canada Deposit Insurance Corporation	To review recent experience with deposit insurance schemes and consider the desirability and feasibility of setting out international guidance for such arrangements	The Study Group identified common features essential to an effective deposit insurance system, recognizing the different public policy objectives that account for the wide range of deposit insurance systems.	The group submitted its report to the FSF in March 2000. The FSF welcomed the report and asked the Group to consult widely in developing international guidance for deposit insurance arrangements.

Source: Financial Stability Forum, 19 May 2000

Annex D

Key principles for reform of the IMF

1. The IMF should play the central role in promoting macroeconomic and financial stability as an important precondition for sustainable global growth and should continue to evolve to meet the challenges of the future.
2. The IMF is a universal institution which must work in partnership with all its member countries, based on their shared interests in these goals.
3. To be effective, the IMF and its activities must be transparent to the public, accountable to its members and responsive to the lessons of experience and external and independent evaluation.
4. In order to foster strong policies and reduce countries' financial vulnerability to crisis, preventing crisis and establishing a solid foundation for sustainable growth should be at the core of the IMF's work. Surveillance of economic and financial conditions and policies in member countries and the implementation of internationally agreed codes and standards are primary tools for accomplishing these aims.
5. IMF's financial operations should continue to adapt to reflect the realities of global capital markets while preserving the flexibility to support all member countries, as appropriate, including those with no immediate prospects of market access. They should encourage countries to take preventive measures to reduce vulnerabilities and provide temporary and appropriately conditioned support for balance of payments adjustment, including in cases of crisis, and medium-term finance in defined circumstances in support of structural reform, while avoiding prolonged use.
6. IMF lending should not distort the assessment of risk and return in international investment. To this end, the IMF should take appropriate steps to ensure that the private sector is involved both in forestalling and resolving crises, which should help promote responsible behavior by private creditors.
7. While the World Bank is the central institution for poverty reduction, macroeconomic stability – a key tool for the achievement of poverty reduction and growth – is the responsibility of the IMF. The IMF has the crucial role in supporting macroeconomic stability in the poorest countries through the Poverty Reduction and Growth Facility, integrating its efforts with those of the World Bank in working with countries on poverty reduction strategies.

Source: Report from G7 Finance Ministers to the Heads of State and Government, Fukuoka, Japan, 8 July 2000.