# The International Monetary System. The new financial architecture: from substantive to procedural rules *

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## 1. A rapid bird's-eye view of history

This year marks the 60th anniversary of the Bretton Woods Conference, which saw the architects of the future world order meeting as war still raged to forge the rules that were to govern trade and above all exchange between the nations. Much has been said and written of the approaches taken by Keynes and White, the latter eventually winning the day;[1] Keynes envisaged the creation of a supranational bank and currency while White advocated the institution of a fund for international stabilisation (Cesarano 2000). The difference between the two approaches seems more a matter of the institution that would be entrusted with managing the system and its *modus operandi* than of the economic vision to be implemented in a world living in peace once again: freedom of trade and payment for current transactions, control over fugitive funds or floating funds, fixed exchange rates to be maintained as long as no radical imbalance emerged and credit granting by a new institution, the International Monetary Fund, to ensure that the adjustments necessary to avoid exchange crises were neither too drastic

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* On these issues, allow me to refer readers to some of my publications and the bibliographies supplied with them (Sarcinelli 1999, 2000, 2001a, 2001b). This paper has greatly benefited from helpful comments on an earlier draft by Marcello de Cecco and an anonymous referee. The usual disclaimer applies.

[1] For a detailed account of how Keynes and White came to their respective positions and how they succeeded in reconciling them, see Gardner (1956) and Skidelsky (2000).

nor took too heavy a toll on the community. As Carli (1995, p. 61) was wont to recall, the aim of the US Treasury Secretary, Morgenthau, was to drive the usurers out of the temple of international finance and create institutions to be at the service of sovereign governments, and not of private financial interests. The evolution followed by the IMF in the 1960s was, presumably, much as Keynes had imagined it in 1945 (Cartapanis and Herland 2002, p. 281).

Between '71 and '73, having gone through the 'dollar gap' phase, the crisis of the double gold market and the growing reluctance of the US to convert dollars into the yellow metal,[2] the system collapsed. Bringing it under heavy stress were the US external deficit, increasing controls over capital flows, the impossibility of raising any defence against imported inflation, and finance once again taking on an international dimension on the eurodollar markets. Although the abandonment of fixed parities was justified as being a temporary measure, a flexible exchange system between the major currencies inevitably set in after the two oil shocks of the 1970s, which gave a further boost to the international role of finance through the recycling of petrodollars. At Kingston, Jamaica, in 1974 the fixed or floating exchange system became an option open to each member of the IMF. Thus the system lost consistency, capital movements enjoyed ever more freedom, and international liquidity, which had hitherto depended crucially on the deficit of the country issuing the reserve currency, became the prerogative of the demand and supply expressed by countries and enterprises.

As a formal, institutional structure, the IMF remained unaltered while an informal structure emerged with the G5, which subsequently became G7 and more recently G8 with the inclusion of Russia. The flexible exchange rates should have responded fairly rapidly to the varying growth potential and inflation of the economies, but in practice they revealed a tendency to cumulative misalignments prolonged over the years. Hence the Plaza and Louvre decisions and deliberations hammered out in innumerable meetings with the aim of influencing the exchange rates, more through declarations than with actual intervention. The exchange rates showed no precise trend in the

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[2] A certain conservative spirit had the effect that the special drawing right created in 1969 to increase reserves proved a failure, and that years later the substitution account to reduce the dollars in the reserves aborted.

direction of self-regulation, nor, for that matter, did the flows of funds *vis-à-vis* the repayment capacity of the debtor countries; with the oil shocks playing their part, the 1980s represented a lost decade for the developing countries, and in particular the Latin American countries fraught with crises arising from the impossibility of servicing their debts. Increasing demands were made on the IMF and various other international public financial institutions to collaborate in addressing the indebtedness of the developing countries and, subsequently, also of the countries in transition, tempering the monetary role of the IMF with a mixing of the missions represented by the various institutions in the interests of development and the fight against poverty.

Precipitating crises have seen exchange rate and banking system increasingly caught up together in their throes, with the debt possibly drawn into the vortex, too. The IMF has responded at the ideological level by applying the 'Washington consensus', with its insistence on fiscal discipline, privatisation, liberalisation of rates, exchange, capital flows, and so forth. At the operational level the response has been to extend the various forms of financial assistance and, above all, conditionality to the most sensitive aspects of the economy, namely the structural components. The 1997 crisis in South East Asia cannot simply be traced to the exchange crisis archetype: rather, it seems to have been a matter of a profound, systemic financial crisis spreading the local shock to the entire region and the various segments of the financial markets. Con-causes have been seen in the freedom of capital movements, implicit or explicit assurances on exchange rates or credits, and the possibility of multiple equilibria able to bring about the sudden transformation of the scenario from benign to malign (see § 4).

With the increasing liberalisation of capital movements emerging ever more clearly as a factor that could aggravate the risk of crisis, 1997 saw the Interim Committee in Hong Kong approving an amendment to the IMF Articles of Agreement that included the liberalisation of capital movements among the aims of the Fund, as an element essential to an efficient monetary system in an age of globalisation! The mandate of the institution created at Bretton Woods had been overturned: many countries, including the major nations, were faced with a shift from fixed exchange rates[3] to floating – from the

[3] The practice began to recommend to countries wishing to remain anchored, given the size of the economy, the degree of commercial integration with the domi-

possibility of keeping capital under control to total freedom, extended also to the flight and floating category.[4]

The South-East Asian crisis proved serious enough to persuade the G7 Finance Ministers assembled at the 1999 Cologne summit to take up the recommendations that the G22 [Willard (Hotel) Group] – created on instigation of the United States – had thrashed out through three working groups;[5] in the meantime there had also been the Russian, LTCM (Long-Term Capital Management) and Brazilian crises. The G7 Ministers recognised that reducing risks and enhancing international cooperation were the essential requisites to keep the process of globalisation moving, and with it the financial integration that formed an indivisible part of it. If the end was to be achieved, however, governments had to acquire a fuller awareness of the consequences of their macroeconomic policies, while the rules of the game for markets and their participants also needed clearer definition. The proposals for modifications were summed up in 60 points, falling into four broad categories.

1) Stress was placed on the need to enhance the transparency and quality of information as a necessary condition to improve the working of the international finance markets; for the developing countries above all this is a matter of increasing both the supply and qualitative robustness of information on the macroeconomic situation, net currency reserves and the soundness of the financial institutions, etc. The means to this end is to be found in the development of codes of conduct and of improvements in standard practices by a variety of international organizations and, of course, their adoption by the countries concerned, with the IMF overseeing their correct application (see §§ 3 and 8).

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nant economy or the desire to import stability from outside, to adopt the 'currency board', which entails foregoing monetary policy.

[4] The liberalisation of capital movement came in for its share of critical appraisals, as for example from Stiglitz (2000, 2004). It is still a controversial issue, as demonstrated by the project for independent assessment of the IMF approach to liberalisation of the capital account (IMF-IEO 2004). On the other hand, some evidence has been collected by the IMF itself on the presence of a 'threshold effect' in the relationship between financial globalisation and economic growth in the developing countries, and their failure in reducing macroeconomic volatility subsequent to international financial integration (Prasad *et al.* 2003).

[5] Constituted in 1998, the G22 briefly grew into the G33 and in 1999 shrank back to the G20 for cooperation and consultation on matters regarding the international financial system.

2) The principle of freedom in the movement of capital is reaffirmed as serving for optimal allocation of saving at the worldwide level[6] and consequently for growth and employment in the areas where it shows the highest productivity, although it may in crisis-prone parts be tempered with certain forms of control, such as the type temporarily introduced in Chile with short-term capital inflows heavily penalised by requiring non-interest-bearing deposits; a correct sequence was also recommended in the process of liberalisation, although it does not seem to have been respected in Korea. A further recommendation was the development of local bond markets to make countries less dependent on foreign funding and above all to reduce the guarantees often given to foreign lenders (see § 4).

3) A certain agnosticism was still being shown over foreign exchange regimes, but the point was made that anchorage to other currencies calls for more cautious fiscal policies and a prudent curb on short-term indebtedness abroad.[7] For the private sector the need was stressed to eliminate incentives to venture upon excessive risks by stepping up on regulation and supervision of financial intermediaries, to be achieved through international cooperation and respect for codes of good conduct (see § 3).

4) Finally, it was recognised that if, despite the improvements mentioned above, crises continued to arise, then steps would have to be taken to contain contagion, entailing greater international collaboration, far more limited and 'conditioned' IMF intervention than hitherto to reduce moral hazard, and increased involvement of the private sector, called upon not only to provide liquidity but also to bear the consequences of the risks incurred (see § 5).

## 2. The position of the American academics

At this point it is worth considering the positions taken by a number of authors specialising in international money matters on the widely

[6] For a critical position, see Bhagwati (1998a, 1998b).

[7] For Edwards (2001), with the right conditions and policies the floating rates can prove efficacious and efficient for the developing countries.

hailed new international architecture. We shall take in rapid review volumes by Goldstein (1999), Eichengreen (1999) and Kenen (2001);[8] published subsequent to Robert Rubin's architectural reference in his 1998 speech and – at least in the case of the first two – more or less at the same time as the Cologne declaration of the G7 Ministers, they offer a fair cross-section of academic reactions to what was being thrashed out at the technical level and proposed on the political plane.[9]

The Goldstein report was produced by a work group under the auspices of the Council on Foreign Relations. It takes a moderate approach to reform, seeking to contain the systemic risk and encourage market discipline, which it sees as having been somewhat neglected in recent times (p. 13). The report does in fact recognise that market failures call for response of an institutional nature, but holds that it should be kept to the minimum possible in order to leave greater room for the market forces. In the light of the more recent crises, too, it is deemed that the solution is to be sought in a change in the wayward behaviour of governments, restoring the disciplining function of the market and limiting the role of the IMF. As for the business of setting the policies of crisis-prone countries on the right footing, the recommendation is to apply standards, publish lists of the 'goodies' and 'baddies' and provide for the possibility of loans to the former on more favourable conditions (pp. 6-8). For crisis management, the primary responsibility in avoiding or addressing them should lie with the developing countries themselves and their private creditors, with no excessive risk incentives being offered through implicit guarantees or easygoing regulation. IMF action is justified by the need to avoid systemic crises, but the extent and cost of intervention must be such as to leave the greatest possible room for market discipline (pp. 11-13); for the IMF, moral hazard can be contained only by having private creditors share in the losses (pp. 101-06).

Eichengreen's publication also reflects a middle way position based on robust incrementalism (p. 5) and profuse in pragmatic pro-

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[8] For accurate reconstruction of the positions of these economists I have a debt of gratitude to Best (2003), who points out that all three volumes reviewed reveal concerns of an ethical nature both in their analysis and in the therapy they propose. Such scruples are by no means foreign to the tradition of political economy and are re-emerging; worthy as they are of close consideration, they are beyond the scope of this paper.

[9] On the European contribution to ideas and action in favour of reform, see Cœuré and Pisani-Ferry (2000).

posals. Nevertheless, his analysis is in strict accord with economic institutionalism, which seems able both to account for the financial crises and to dose the cures he prescribes. He begins from the premise that financial liberalisation entails benefits within an economy, while at the international level it becomes inevitable and irreversible (p. 2). Unfortunately, asymmetric information and transaction costs stand in the way of efficacious market self-regulation, which means that the services of international financial institutions are necessary to prevent and address crises, and for regulation to smooth the way for debt settlement; inevitably, the process is affected by the political context. Eichengreen, too, invokes standards, made necessary and legitimate by the fact that the liberalisation of international financial flows has wiped away the line of demarcation between internal and international financial systems (p. 20). Thus the IMF should come to the aid only of those countries that comply with the standards (p. 23). The second pillar in Eichengreen's analysis has to do with the preponderant role of the banks in the developing countries: it is in fact the preferential, asymmetric access to information enjoyed by these banks that renders them instability-prone; moreover, they are often too big to be abandoned to bankruptcy if they become insolvent, thereby representing a source of moral hazard (pp. 38-40). In this respect he proposes, for the long term, diversification of the financial structure from banking to the financial market (p. 38), for the medium term enhancement of prudential regulation based on international financial standards (pp. 43-48), and for the short term taxes on capital imports to prevent excessive risk-running (pp. 49-55).

In his study on international financial architecture Kenen recognises the fact (e.g. on p. 111) that market discipline comes up against a great many limitations, both in laying down standards and in settling debt crises, thereby implicitly acknowledging the institutional nature of the market and the need for it to be modified through political response to events. The incautious reaction of the governments to capital inflows was not the only cause of the financial crisis that hit South-East Asia: factors creating the conditions for it to break out included the speed-up in capital account liberalisation, an exchange rate not free to fluctuate, herd behaviour, etc. (p. 27). In order to change the economic behaviour of governments the only hope lies in international standards, but their application cannot be left entirely to market discipline, nor can it come about along the same lines followed

in the advanced countries, to meet whose needs the standards were devised. What Kenen proposes is a contractual approach between the parties concerned, or in other words between the government of a country and the IMF (or World Bank). And what matters here is the rate of progress towards a situation less fraught with risk, rather than conformity to an abstract model (pp. 131-32). As for the point about the private sector taking a share in the crisis costs, he comes out in favour of an obligatory moratorium in debt payments in order to curb panic through legal mechanisms of internal source (pp. 143-50). On the need to limit IMF financial assistance or reserve it solely for the countries pre-qualified to receive it Kenen shows a certain scepticism (p. 152).

From this rapid review of the ideas aired by three of the major authorities on the international monetary system it emerges that, despite their different conceptions of the market and its role, they see the solution to reduce the risk of crisis as lying in reform of the behaviour of governments through the application of international standards and a more wary approach to the liberalisation and management of capital movements. As for the cure to fall back on should crisis break out despite environmental improvements, it lies not in the international socialisation of debt burdens, but in having an appreciable part paid by the private sector which had gained initial benefit from reckless decisions. Thus the need is for reduction in the role of the IMF as supplier of liquidity and increase in its responsibilities as supervisor of government conduct and regulation.

## 3. Reform action

Adjustment of the IMF (and the World Bank, as far as its province was concerned) to the G7 directives began quite briskly, brought into effect by the decisions of the Interim Committee, renamed – above all on the insistence of the French – the International Financial and Monetary Committee. Twelve areas were designated as crucial to the improved functioning of the international monetary system, and for each of these a series of standards defined as serving the interests of the

IMF and the World Bank operations.[10] Drawing up standards was a task involving not only the IMF and World Bank, but also the Basel Committee for Banking Supervision and yet more organisations; moreover, the Financial Stability Forum was also constituted for the purpose (see § 8).

Since defining principles and elaborating regulations does not necessarily lead to their adoption and application, the need arises for at least some form of supervision and moral suasion on the part of international institutions. Accordingly, the IMF and World Bank draw up reports on the observance of standards and codes in each of the areas, and with the consent of the country concerned they can be published. Given their importance for the purposes of stability, the reports dealing with standards in the financial sector are normally drawn up in the context of the 'Financial Sector Assessment Programme', which is managed jointly by the IMF and World Bank and is designed precisely to assess the strong and weak points in the financial sector of each country.[11] Obviously, this type of surveillance was introduced in the 1990s in terms of article IV of the Articles of Agreement, together with institutional aspects such as the independence of the central bank, the policy of transparency and corporate governance, although the mandate had already come into effect in 1977 specifically with reference to exchange rate policy, macroeconomic conditions and the strategic policies of each country, and in the 1980s extended to the structural policies ranging from energy to the labour market, international trade, etc. A voluminous overview of the work of the various offices is published every two years (IMF 2004). A point stressed in the latest report was that the coverage of issues related to the financial sector had yet to be brought to the same level as the other areas constituting basic surveillance; not only does the range covered vary greatly from country to country, but also for the industrialised countries the indicators of financial soundness were often limited to one category

[10] The areas comprise: accounting, dissemination of data, corporate governance, insolvency and the rights of creditors, regulation of securities, auditing, payment systems, insurance supervision, bank supervision, fiscal transparency, transparency in monetary and fiscal policy and, as from 2002, also combating monetary laundering and the funding of terrorism; actually, the latter has more to do with policing in a globalised world than with rules for the physiological functioning of an international monetary and financial market.

[11] On the growing importance of the prudential problem and IMF responsibilities as lender of last resort, see Aglietta (2000).

alone – that of earnings and profitability[12] – while the soundness assessments were not backed up with sufficient evidence (IMF 2004, chapter *Content of Surveillance*, pp. 17-18). That the financial aspects have assumed as much importance in the eyes of the IMF as the macroeconomic is also demonstrated by the fact that along with the *World Economic Outlook*, which has for some time been coming out semi-annually, we now see the *Global Financial Stability Report* published with the same frequency; the idea is that, with the evidence provided by the two periodicals, it should be possible to identify, in the light of the current trend, potential systemic weaknesses able to generate a financial crisis.

Can it, then, be said that the efforts promoted by the 'Washington consensus' and the G7 to advance higher standards among the governments of the developing countries have actually reduced the risk of crisis? On the one hand, it is too soon for us to tell[13] since, despite all arguments to the contrary, it does take time for behaviour to change, while on the other hand the less than satisfactory level of coverage and assessment of respect of codes and standards in the financial area leave room for doubt. However, in the interests of prevention the need is for the country potentially heading for crisis to adopt: *a*) prudent macroeconomic policies; *b*) a foreign exchange regime having no implicit insurance for agents, above all if the movement of capitals is largely liberalised; *c*) a policy to stem crisis vulnerability; *d*) enhancement of the banking and credit structures to prevent transmission of possible currency shocks to credit and investment financing; *e*) transparency in policies, such that markets can have a clearer idea of the fundamental conditions of the country – obviously it helps here if standards are applied to banking regulations, public finance procedures, collection and publication of statistical data, etc.; *f*) policies to sanitize sources of contagion from other economies through sudden worsening in market expectations *vis-à-vis* the general economic climate or that of a category of countries, which can swing the equilibrium from benign to malign for the country concerned; *g*) finally, in the case of countries developing or in transition, reactivity comparable with that of the advanced economies in terms of cutting back the public sector, privatisation, liberalisation, accountability, etc. Since

[12] Besides earnings and profitability, there are also adequacy of capital, quality of assets, liquidity and sensitivity to market risk.

[13] In this respect see also Saccomanni (2002, p. 176).

much of the activity dedicated to creating a 'new international architecture' has in recent years consisted in extending prescriptions drawn up by and for the developed countries, adoption of them by the weaker countries is often hamstrung by the lack or inadequacy of social security systems, scant efficiency in the public administration and, in some cases, corruption. It is therefore hardly surprising if crises are still breaking out, at least for the time being, although contagion has to some extent been curbed: Argentina may be an emblematic case in terms of failure, but let us not forget the happier outcomes in the case of Turkey and various other, minor countries.

## 4. The endeavour to forecast crises

If crises are – hopefully – to be reduced, although not eliminated, forecasting methodologies are called for that do not stop short at biannual publication of reports on the macroeconomic and financial conditions of a globalised world. Forecasting means detecting signals of looming crises and devising models producing response with an acceptable ratio between event and false alarm.

By the time the South-East Asian crisis broke out two generations of models had been developed at the theoretical level, the first attributing crises to the inconsistency between fixed exchange rates and economic fundamentals, the second to changing expectations due to worsening growth and/or inflation performance and the consequent shift from benign to malign equilibrium. In the case of South-East Asia it was by no means easy to see signs of deterioration in the macroeconomic picture able to generate self-fulfilling expectations, and attention consequently shifted to the liberalisation of capital movements and weakness in the banking and financial systems, thus giving rise to a third generation of models. One version highlights sudden change in expectations, herd behaviour and financial panic (Radelet and Sachs 1998), while another focuses on implicit guarantees, moral hazard and "crony capitalism" (Krugman 1998, Corsetti, Pesenti and Rubini 1998).

It was only with the first generation of models that efforts could be limited to monitoring the balance of payments fundamentals, the foreign debt, the conditions of public finance, the level of currency

reserves, the supply of money, etc. With the second generation crises were already being seen as totally unpredictable events, only in part due to the economic fundamentals. Over and above all these phenomena, in a world of floating exchange rates and financial globalisation the third generation of models has to extend investigation to: *a*) vulnerability, i.e. the defence or resistance capacity of a currency if it comes under attack; *b*) the international financial markets and interaction with the domestic markets; *c*) 'market sentiment', i.e. the information that can be deduced from the prices of financial activities or the developments shown by other countries in similar conditions.

For some time now efforts have been under way to construct not only vulnerability indicators but also models able to diagnose oncoming currency crisis, although no great forecasting capacity has so far been achieved. We have a study (Berg and Pattillo 2000) summing up the conclusions drawn from examination of the simulations of four models carried out in a previous work (Berg *et al*. 1999). Of the variables included in these models the most promising in terms of early warning are a real exchange rate overvalued in comparison with the trend, growth in internal credit and the ratio between M2 and currency reserves. Other variables prove significant only in certain models. More recently the IMF returned to the issue (IMF 2003), undertaking on the basis of recent experience to construct 'building blocks' by means of which to seek to foresee not only currency but also banking crises and others arising from excessive indebtednesses, while also attempting to trace out the links between them, make greater use of the information that can be deduced from the prices of derivatives and study the factors determining contagion. In a recent research work, again carried out under the IMF, the authors (Berg, Borensztein and Pattillo 2004) confirm that assessment of the forecasting capacity of early warning systems for foreign exchange crisis yields mixed results. Only one of the two long-period models developed within the IMF gave satisfactory results in comparison with non-model-based forecasts such as the assessments of rating agencies and the scores attributed by private analysts for foreign exchange crisis risk, while the other model does not appear to have yielded clear indications. Two short-period models devised by Goldman Sachs and Credit Suisse First Boston respectively yielded only disappointing results.

For its part, the BIS has produced indicators for bank crises (Borio and Lowe 2002) but warns that they can at the most take their place among the means to assess the vulnerability of a banking system: starting from a small set of variables including credit, asset prices and the exchange rate it appears possible to detect mounting tensions able to trigger crisis; calculating the deviations from the trend shown by these variables composite indicators can be constructed and diverse forecast horizons accessed. Unfortunately, although research is making some progress in these areas, forecasting crisis – in foreign exchange, banking and/or public debt – remains a quasi-divinatory art. In any case, it is easier to foresee whether crisis will occur at all than to tell when this will be.

## 5. Crisis therapy

Should prevention fail, whether the crisis had been forecast or not, it needs curing with help to the economy thus hit. From its very origin the task of the IMF has been to supply credit for temporary financing of the balance of payments disequilibrium in countries hit by crisis in order to avoid over-drastic adjustments, with repercussions on employment, and/or competitive devaluations.

With fixed exchange rates and control over capital movements, the balance of payments was determined by the current account, but with funds free to flow and growing masses of money chasing after the highest returns, the balance of payments is now dominated by the financial account, with the consequence that while IMF intervention used to help defend employment it is now held to be instrumental in saving the lenders, who are thus able to accumulate low-risk, low-cost credit positions, especially when the authorities are, *de facto*, on their side, having anchored the exchange rate to a certain level (De Gregorio *et al.* 1999). Actually, IMF intervention has now assumed far vaster proportions than of yore. For Mexico in 1995, of a $ 50-billion aid packet the IMF took on 17.8, representing five times that country's quota; for Korea in 1997, of $ 57 billion the IMF contributed 21, i.e. 20 times its quota. Coming closer to home, in support of Brazil in 2002, when markets were shaken at the prospect of victory by the left-wing candidate in the presidential election – borne out by the actual

results – the IMF undertook to allocate $ 30 billion, nine tenths of the sum being conditional upon keeping the existing policies in force in 2003.

In this new situation, with the financial account playing the leading role in the balance of payments and current account no longer scraping in finding its counterparts there, it is financial capital that proves most reactive to expectations, often favoured by a foreign exchange regime affording guarantees of stability: while a sustained inflow of financial capital is certainly able to boost a growth phase, it is also highly likely to set asset prices rising. When crisis strikes through the abrupt withdrawal of funds, social-economic justifications for the use of international public resources lose a great deal of ground if they do not actually vanish away. Calls therefore came for a more sparing use of IMF credit facilities, revision of all those that did not contain some sort of intended subsidy and, above all, the introduction of a 'contingent credit line'. The United States in particular championed this latter point with the idea that it was to serve as a sort of financial lifeboat for members who followed rigorous economic policies, and as preventive defence against possible balance of payments difficulties arising from international contagion. The conditions for access, by no means guaranteed, and for cost, which were particularly penalizing, and indeed the very concept of pre-qualification, which assumed unchanged behaviour persisting through changing political situations, rapidly led to reconsideration of the harshness of the regulations disciplining it. When it came up for renewal on 30 November 2003 the IMF Board of Directors let it die a quite death: not one country had made use of it.

In order to offset criticism to the effect that IMF presence tended to socialise losses when member countries ran into difficulties, it was proposed that the private fund lenders, who had obtained high returns on their investment, should be made to bear at least part of the rescue cost. Thus efforts were made to get member countries to involve the private sector in the application of appropriate policies,[14] having risks duly assessed, keeping up the dialogue with private creditors and creating mechanisms that could prove helpful in crisis situations, such

[14] We may cite the Chilean example of control over capital flows by requiring non-interest-bearing deposits, although according to Edwards (2001) this might not prove efficacious in other scenarios.

as securing credit lines to be drawn upon when problems arose and including collective action clauses (CAC) in bond issues (Rey 1996). In practice it was found that 'technical' problems prevented the former from actually being activated when the recent Argentinean crisis was under way, whereas, after a lengthy spell of dithering, the latter found their way on the New York market once Mexico had blazed the path in March 2003.[15] Thus we see revived a practice that came into being in the latter half of the 19th century in the United Kingdom, and in the 1930s in New York.

## 6. Judging the policies pursued

Over sixty years of life the IMF has naturally had its ups and downs. Nevertheless, a coolly objective judgement is by no means easy: the IMF is a tool of international policy, which is influenced over the various phases of history by the hegemonic member, the ex imperial powers and the relations they have with countries in difficulty, and by the fear that failure to step in to rescue a country may lead not only to contagion, but also and more importantly to systemic risk breaking out, and to correspondingly more dramatic effects, the more complex and intertwined financial structures are. Judgement will of course also vary according to the source – whether within or without the IMF bureaucratic structure itself.

The fact remains in any case that countries resorting to it tend to stay under its care for long periods of time, and some have never left its protection. According to a study conducted internally by IMF economists (Ul Haque and Khan 1998), the adjustment plans funded by the IMF have 'on balance' proved successful. Generally speaking, they have managed to bring the real foreign exchange rate significantly down, improving the balance of payments by means of the depreciation (Bird 2001). However, the restrictive effects on monetary and fiscal policies have proved not particularly significant, those on infla-

[15] As from March 2004, 90% of the new issues in New York have contained collective action clauses, standardised today at the level of 75% for the decision-making quorum, while 40% of the emerging countries' stock in circulation is so provided; of the mature economies only Italy has made issues on this market with such clauses. Stocks provided with CACs are also issued on the London and Tokyo markets.

tion generally insignificant, and those on economic growth decidedly negative. Judged by the parameters befitting the IMF institutional objectives, the high rates of recidivism, low rates of completion and scant catalytic effect in attracting private capital to the countries in difficulty demonstrate that the macroeconomic approach recommended for adjustment and/or the conditionality do not work enough, if indeed they work at all. Moreover, from the 1995 Mexican crisis on, and with the exception of the Brazilian crisis of 1999, adjustment in the current accounts has by far exceeded the planned adjustment (Ghosh *et al.* 2002).

Finally, suffice it to recall the recent case of Argentina, hailed as a model member in following the policies of liberalisation, privatisation and monetary rigour through the 'currency board', only to emerge from political, economic and financial crisis as a country loath to recognise its international obligations, whether at the private level or with the IMF itself.[16] And let us not forget the controversy over the therapy initially prescribed for the South-East Asian crisis (Stiglitz 2002). It is in any case undeniable that three quarters of IMF resources are currently absorbed by just five debtor countries with a particularly high concentration of risks.

## 7. Innovative solutions for the international financial system

It is hardly surprising that frequent crises and the ambition to structure the international order in the image of the institutional process which developed within the most advanced countries led to ideas of instituting – over a very long-period perspective – a super-regulator of international finance (Kaufman 1998), a world financial authority (Eatwell e Taylor 2000), a global central bank (Garten 1998) or a universal currency (Cooper 1984).[17] Now, the idea of a worldwide monopoly of power, either as totality or in certain of its dimensions, is a utopia worthy of respect, but doomed alas to remain no more than that.

The various proposals that combine reformist radicalism with a sense of reality in variable proportions would turn the IMF into: *a*)

[16] On the fiscal disorder of Argentina as cause of the country's difficulties, see Mussa (2002).

[17] On these topics see Rogoff (1999).

lender of last resort, which necessarily entails a role as international financial crisis manager (Sachs 1995, Giannini 1998, Fischer 1999), in order to trace out for it a path along the lines that led the issuing banks to become central banks; however, this would give rise to moral hazard problems unknown at the national level and unmanageable at the international level; *b*) insurer of an economy, or, better, assessor of the limits to insurability (Soros 1998) of credits granted to a country, with consequent distinction between those covered by international guarantee and the other, surplus credits, lacking any such cover; however, managing the scheme would be no simple matter in an international context where the political and strategic position of the country has its weight, as also does that of the creditor quite often; *c*) an international bankruptcy agency or court for sovereign debts (Eichengreen and Portes 1995), thanks to which risk-happy investors could be made to bear the costs of their decisions. Today this objective cannot be achieved without declaration and management of a country's insolvency, but it is open to no end of objections since countries cannot be placed under receivership as if they were business concerns. The sovereign debt restructuring option recently found a champion in Anne Krueger (2002), the present First Deputy Managing Director of the IMF, in the conviction that it could follow a pattern similar to company restructures, with incentives for debtors and creditors to find an agreement in 'the shadow of law', instead of settling in court (Krueger 2001). The idea was positively appraised by an Italian author, alas no longer with us (Giannini 2003). Once the ground had been tentatively sounded out, the impossibility of getting any further along such a path was recognised at the 2003 Spring meeting of the International Monetary and Financial Committee and the proposal was shelved, although the mandate was given to look into certain minor points.

Among American politicians, above all, but also among some economists – not only of conservative leaning like Meltzer (1998), but of more liberal bent, like Sachs (1998) – there is a strongly radical current demanding closure of the IMF or at any rate drastic transformation, and of course its sister institution, the World Bank, does not escape such iconoclastic fury either. Given a scenario that sees the state steadily downsizing its role in the national economies, one could hardly expect the Bretton Woods institutions to have remained unaffected by this atmosphere of retreat, having represented the interventionist spirit on the international level up to the end of the 20th cen-

tury, or very nearly. According to the majority of the Meltzer Commission (2000), the freedom of capital movements and the conviction that the market is perfectly able to manage the allocation of resources and enforce its discipline suggest that the public credit function, now much reduced in comparison with the private function, should be eliminated in the case of the World Bank and drastically downsized and reformulated in the case of the IMF, defined a 'quasi lender of last resort'.

Far from having died out, such ideas have recently been reasserted by Rogoff (2004), IMF Chief Economist until a few months ago. He rightly points out that the World Bank is a hybrid intermediary (long-term bank, aid agency and centre for financing technical assistance) with a credit portfolio containing hidden actuarial costs for the tax payers of developed countries; as today we have a flourishing, liquid international capital market, the World Bank credit windows can be shut down and its activities restricted to distributing 100% of the IDA (International Development Association) funds with no charge. For the IMF the suggestion is no less drastic: since $ 150 billion of resources seem enough to create problems of moral hazard, but inadequate to cope with a truly serious global financial crisis, and since IMF management is too politicised to perform the lender of last resort role with equanimity, it too should abandon the credit function and confine its work to coordinating the global financial system, offering technical assistance, answering obligingly to requests from countries for rating their debts, and so forth. There are indeed some who advocate making the IMF lender of first resort (Cohen and Portes 2003) for countries undertaking not to cross the unsustainable debt threshold and anxious, therefore, to avoid self-fulfilling crisis, but this seems like a practically desperate defence of the IMF credit function.

## 8. From a system with substantive rules to one with procedural rules

If it is to survive and be comprehensible, no system can do without rules, and rules deriving from limited human rationality give rise to institutions. This means that not only prices are important for the

functioning of an economy, but also various other institutions ranging from money and taxes to religion and law. The economy is therefore to be seen more as an ongoing process than an optimal state that can or must be achieved. Thus the institutions become structures governing transactions (Williamson 2000), providing the possibility to create an order, reduce conflicts and accomplish collective benefits; the yardstick for the soundness of institutions is therefore to be seen above all in their effectiveness, although efficiency remains important when there are feasible alternatives with superior characteristics.

From the theoretical point of view, international political economy has to do with the economic governing of an environment – that of relations between states – which is sub-structured in the sense that the institutions occupying that area are few, subject to hegemonic influences, and often disregarded by countries holding the regulation in this or that circumstance contrary to their vital interests. Nevertheless, rules and the institutions variously qualified to apply them remain means or tools to achieve the coordination that irons out conflicts and so clears the way to collective benefits. As in the case of internal regulation, the rules can be procedural or substantive, significantly discretional or severely binding: at the international level, naturally, rules of a more procedural, discretional nature tend to prevail.[18]

For authors like Krasner (1982), the set of rules, standards and procedures ensuring coherence for the decisions of the international agents constitute the international system. The old Bretton Woods system was a well-structured example in the area of foreign exchange, monetary and financial relations, but the new system that started taking shape as from 1971-73, and which the new international architecture set out to endow with greater cohesion, is totally different. Any student of economics will be quick to conclude that the previous system gave rise to rules and behaviours according with fixed foreign exchange rates, the dollar as reserve currency and liquidity created by the United States' external deficit, while the later system has flexible exchange rates – at least among the major currencies – , would have no need of reserves but accumulates them, and leaves to the markets the responsibility of creating and distributing liquidity.

[18] For some of these points I am indebted to Cartapanis and Herland (2002).

From the point of view of the system itself, however, it appears evident that the former had substantial rules precisely defining what each of the participants was to do – including control of capital flows – in order to remain within the limited band of exchange fluctuation *vis-à-vis* the dollar, provided no fundamental disequilibrium was at work, and established that the reserve currency should on request of a central bank be converted into gold. This framework of substantial rules was under the supervision of an institution – the IMF – which exercised surveillance over the functioning of the system, allowed for variations in parity when necessary, and extended credit to soften the social impact of macroeconomic adjustment.

What emerged from the collapse of Bretton Woods is a completely different system, showing a marked degree of heterogeneity with flexible exchange rates in operation alongside other, fixed rates freely decided upon by the various countries, and markets having the responsibility for moving inflow and outflow of funds on the basis of the information available and the hopes and fears animating it;[19] there are virtually no substantial rules, but a great many procedural ones taking the form of guidelines, codes of conduct and best practices. For these broad principles to be circulated and accepted recourse is made to incentives and moral suasion, respecting national sovereignty, the prerogatives of the central banks and the freedom of the markets. The IMF is, I feel, left as a sort of Pirandellian hero in search of an author; not only the academics but also the experts in the field have foreseen its transformation (see § 7), seeking to entrust it with all sorts of tasks. Today it is in practice a sort of institution for supervision – not only macroeconomic, but above all financial – in endeavours to guarantee greater stability through 'virtuous' behaviours favoured by a more widespread acceptance of transparency.[20] The more radical critics would like to see it deprived of all faculties to extend credit, apprehensive as they surely are about moral hazard but above all aware that this function is a hangover from an obsolete system.

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[19] The definitions of the system range from a somewhat scathing "non system" (Padoa-Schioppa and Saccomanni 1994, p. 235) to others more respectful of the reality of a "global financial system directed by the market" (*ibid*, p. 240) and "private international monetary system" (Carreau 1998, p. 311).

[20] It is, however, often forgotten that transparency can reduce uncertainty about the present but not about the future, and that its role in subjective risk assessment is ambiguous.

The new international architecture has been brought onto the scene to endow with greater coherency a system that was taking shape from the bottom and reacting to the pressures of the market and financial conjunctures – frequent sources of crisis. The definition that has been supplied (Crockett 2000) as a set of rules, guidelines and practices regulating international financial relations, like the various institutions and associations responsible for their development, monitoring and observance, suggests something more organic and more grandiose than the reality it should represent.[21] In this respect it must be acknowledged that the Financial Stability Forum, set up in 1999 subsequent to the *Tietmayer Report*, is the only body specifically created to enhance coordination and exchange of information between the various authorities responsible for financial stability, as well as assessing the vulnerabilities of the international financial system and coming up with remedies. Otherwise, we are left with groups of countries and central banks, associations of regulators and supervisors, international organisations and professional and market associations. Thus there arise problems of legitimation, representation and the distribution of competences, and these problems in turn become involved with the 'products' of the various bodies, their acceptability not being entirely independent of the reputation or power of those who defined the rule, standard or guideline, as indeed is borne out by the keen contention over Basel II and the controversy over art. 39 of the international accounting standards on 'fair value'.

Actually, none of these 'products' is in itself strictly binding; they are usually defined as 'soft laws', with no coercive force and no sanctions to be feared. Translation into 'hard law' is up to the individual legislation, which may obviously incorporate them only in part or not at all, or depart from the recommended text if deemed expedient. Now, international treaties take a long time to negotiate, are often lacking in flexibility and not infrequently drawn up in more diplomatic than technical language, and there are evident advantages in the process of producing 'soft laws', which can, however, easily become weak points in cases of dispute (lack of precision, uncertain status of the rule in a given legislation, etc.). A further point to bear in mind is that democratic legitimation plays practically no part in the produc-

[21] For these considerations I am indebted to Giovanoli (2000). On 'soft law' see also Giannini (2002).

tion of these regulations. Naturally, the moral suasion exerted by the hegemonic power and the incentives are means to lead the countries concerned to comply with the rules, standards and practices of the 'soft law', while the market incentives work on assessment of risk and the cost and availability of credit. For the IMF and World Bank they can make themselves felt through the conditions and volume of assistance to countries having recourse to it, but one cannot but wonder what sort of moral suasion could be exerted in supervising rules, standards and practices if they were to be divested of their lender roles. Such an eventuality would inevitably spell further advance in international financial de-structuring.

## 9. What are the ideas for tomorrow's IMF?

As I noted in my introductory remarks, this year marks the 60$^{th}$ anniversary of the Bretton Woods Conference, and it is an appropriate moment to be asking what the intentions of the IMF top officials are for the future of the institution.

The new Managing Director remarked a few months ago in Madrid:

> "The breakdown of the Bretton Woods system, and the adoption of floating exchange rates in many countries, marked a radical departure from the world of pegged rates that the IMF was set up to monitor. The IMF's member countries amended the Articles of Agreement to give the institution a mandate to carry out a regular, comprehensive, analysis of the economic situation and policies of each member country. This remains the essence of the Fund's surveillance function" (de Rato y Figaredo 2004, p. 1).

The rest of the address follows a thoroughly orthodox approach in covering the promises and hazards of global capital flows, enhanced surveillance and improved crisis prevention and resolution, promotion of financial stability achieved also through the credit function, and the role of the IMF in the worldwide fight against poverty.

Ten days later he was echoed from Reykjavik by the First Deputy Managing Director. In the "Looking to the Future" section – the last – she observed:

> "It is clear that while much has been accomplished, the Fund's agenda remains a full one – and, given the nature of the evolving world economy, it always will. Maintaining international financial stability is an ongoing process; it is not something that we can put in place and forget about [...]./Just, for a moment, imagine a world without the IMF./Hard, isn't it. How would the lessons of one country's experience be exploited for a wider benefit? How could peer pressure work if there was no forum for debate and discussion? Who would help countries in need of financial support, of technical assistance, of basic policy advice?" (Krueger 2004, p. 8).

No new problem is identified, no new solution foreshadowed.

And yet there is one very real problem, albeit concerning the internal governance of the IMF. As the official IMF historian wrote:

> "Fundamental reforms to ensure that the voices of all countries and regions are represented and heard in proportion to their role in today's world economy will depend on the willingness of those countries that currently hold power to embrace a more flexible system of sharing it" (Boughton 2004, p. 13).

His appeal was echoed by the President of the Foundation Per Jacobsson: "member countries need to agree to a package of measures to obtain more equity in voting power" (Van Houtven 2004, p. 19); moreover, "the size of the Board [of Directors] should be significantly reduced" (*ibid*., p. 20), possibly from 24 to 14 members.[22]

The fratricidal contention for a seat in the United Nations Organization Security Council does not bode well for a solution to the administration of the IMF and World Bank, where the redistribution of power should be achieved through the graciousness of the developed countries in favour of the emerging ones. Such long-sighted acts of altruism (or enlightened self-interest...) are, however, all too rare in the history of mankind, and we must be ready to face a long period of strife.

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[22] On the topic, with reference to Europe, see Bini Smaghi (2004).

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