TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE

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The last three years have witnessed a dramatic turn of events in global finance. As the trend of globalization intensifies, so does each economy's exposure to potential external risks. This is particularly true for small open economies. Moreover, as the Asian crisis has clearly demonstrated, emerging market economies are especially vulnerable to a financial crisis during a bust phase in the domestic business cycle.

The boom-bust cycle is usually marked by a remarkable economic growth period of speculative investment and excessive growth in consumption, followed by a recession that can develop into a full-blown financial crisis. When a domestic bust phase coincides with adverse external shocks, this cycle renders small open economies particularly vulnerable.

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The pronounced trend toward capital account liberalization and global financial integration has put small open economies at even more risk. Crises can be triggered by volatile foreign exchange markets and short-term capital movements. Since the financial crisis in Asia, there have been many calls for addressing the key factors in the international financial system that could contain the volatility and limit their devastating contagion effects.

Enhancing Transparency

The Asian financial crisis has demonstrated the importance of enhancing transparency in the areas of economic policy, regulatory structure, and information dissemination, as well as strengthening international financial institutions' monitoring in these areas.

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In particular, the broad consensus that the surveillance function of the IMF must be strengthened has emerged. Establishing codes and practices ensuring transparency in economic policies, and introducing and disseminating international standards on accounting, auditing, and information disclosure would avert the harmful herd behavior that causes investors to withdraw massive amounts of capital together.

The Asian financial crisis showed how the absence of such international principles and standards applicable to all market participants prevented foreign investors and creditors from properly assessing the macroeconomic policies in host countries and the accounting data of individual enterprises. The Code of Good Practices on Fiscal Transparency and the Code of Good Practices on Transparency in Monetary and Financial Policies by the IMF are steps in the right direction.

For other important areas such as banking supervision, accounting, auditing, and corporate governance, international standards should be established through close cooperation between relevant institutions, including the World Bank, IOSCO, and the Basle Committee on Banking Supervision, and reflect broad national representation and input. Transparency must also be improved in individual countries as well as these international financial institutions.

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International standards will greatly facilitate transparency in emerging market economies. But their adoption by emerging economies should be done gradually and in a "phased-in" approach - that is, through a set of incentives and with technical assistance.

Strengthening the Financial System and Implementing Orderly Liberalization

Financial soundness and efficiency are crucial in economic development and stable growth, particularly when liberalization policies are implemented in the face of increasing global financial integration. Hence, developing countries must concentrate on strengthening their domestic financial institutions and market infrastructure to resist external shocks by reforming the financial sector.

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The first step to financial restructuring is identifying troubled but viable institutions and disposing of their non-performing loans (NPLs) and under going recapitalization. When using pubic funds, it is important to remember that this should be based on well-defined principles such as:

- Embracing effectiveness and efficiency as opposed to a gradualist approach when injecting public funds so as to quickly restore confidence in the market and avoid needless prolongation of the credit crunch.
- Early agreement on a framework for equitable loss sharing among parties will minimize moral hazard problems and the burden on taxpayers.
- Banking sector restructuring should receive highest priority if cross-border restructuring is required within the financial sector.

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Moreover, reform must address the close linkage between the corporate and financial sectors, calling for close coordination between financial restructuring and corporate sector reform. As acknowledged by the G-22 Working Group, improved corporate governance and accounting standards will be critical in strengthening the financial system.

Financial sector restructuring must also pay attention to the feedback linkage between reform progress and macroeconomic performance. Because in the short-term reforms will cause the economy to contract, some degree of macroeconomic stimulus may be needed to secure the sustainability of financial sector reform against continued economic stagnation and social unrest. The goal is to create a virtuous cycle of macro policies that enable active capital markets to serve as a catalyst for corporate restructuring, thereby also facilitating financial sector reform.

Managing Cross-Border Capital Flows

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Increasing international trade, growing financial integration, and continuing technological innovation - despite their obvious benefits - call for enhanced risk management capability. The inevitable expansion of capital flows have put emerging economies at increased risk to market volatility. Because of the challenges presented by active financial flows and capital account liberalization, liberalization policies should proceed in proper sequence, supported by measures strengthening financial supervision and prudential regulation.

Even when economic fundamentals are reasonably sound, the instability of international financial markets exposes small open economies to external vulnerabilities, particularly through the spread of contagion effects and its associated reversal of capital flows. Hence, there must be adequate safeguards in the event of serious balance of payments problems or movements of capital that endanger the economy.

Safeguards also have the effect of allaying public misgivings and political resistance to market opening that make liberalization policies difficult to implement in many emerging economies. But these safeguard mechanisms should be considered the last resort, and their application held to the minimum.

The growing influence of highly leveraged institutions (HLIs) in international financial markets presents another challenge for capital account liberalization.

The growing influence of highly leveraged institutions (HLIs) in international financial markets presents another challenge for capital account liberalization. Hedge funds must be better monitored and supervised. When combined with excessive leverage, the general lack of transparency in their financing and investment practices can destabilize the international capital markets and smaller emerging markets.

It can be said that inadequate supervision of the HLIs contributed to the severity of the Asian financial crisis, although structural problems were the more deeply-rooted cause. Nevertheless, they helped trigger the reversal of capital flows and aggravated the crisis contagion effects.

The need for improved regulation also arises from the fact that a sizable portion of the short-term debts owed by emerging market economies is in part related to derivative transactions involving offshore funds. In particular, credit derivatives constituted the majority of the derivatives. When the market collapsed, the derivative investments resulted in significant losses. This highlighted the need for improved market infrastructure and enhanced supervision of derivative and highly leveraged transactions, which has recently been addressed by the Basle committee.

Increasing Private Sector Participation in Crisis Containment and Resolution

The problem of moral hazard among investors exists because they expect to be bailed out when in financial distress. This problem could be partially addressed by a pre-established program for debt workouts that would include private creditors in the process of both containing and preventing crises, bailing them "in" instead of "out."

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When a crisis-hit government requests assistance from international financial institutions such as the IMF and the World Bank, the provision of emergency funding should be linked to a debt workout program arranged by an ad hoc committee. The objective of this committee would be to decide on outstanding private sector debt, and could automatically roll over liabilities that matured for a specified time period under a rescue package. Creditor banks should also form a sub-committee deciding on debt workout modalities.

Korea's experience suggests a number of lessons in the development of a more effective institutional approach to private sector participation. In particular, the IMF and the World Bank, among other international institutions, should improve their coordination of well-designed crisis management and reform programs. Conditionalities should recognize the unique circumstances of each country, and negotiations on maturity extensions should take place in conjunction with the provision of assistance by international financial institutions to save time and money during a crisis situation.

Strengthening the IMF and the World Bank

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There have been many innovative proposals to revamp IFIs. One way to strengthen the Bretton Woods institutions is to consider establishing an international lender of last resort. Although this is an idea with many technical and conceptual problems that could only be resolved over the next few years, the introduction of a Contingent Credit Line (CCL) is focused on a more immediately achievable goal.

When provided to a member country before the contagion effects set in, a CCL could also mean stronger surveillance and monitoring of reform measures and proper policy implementation. At the same time, in order to better assist the crisis-hit emerging market economies in regaining their market access, the partial guarantee facility of multilateral development banks like the World Bank could be expanded to policy-based guarantees.

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In addressing the problems of crisis-hit countries, IFIs must take a more balanced approach in devising reform packages, particularly with regard to social reform. Also, clarifying the respective roles of each IFI and its associated comparative advantage will enhance the overall effectiveness of crisis management support.

Improving Exchange Rate Regimes

Both maintaining exchange rate stability among major international currencies and the monetary policies of emerging economies are important for global financial stability.

The adoption of an exchange rate regime is inseparable from other economic variables, including macroeconomic policy, level of financial development, and degree of economic openness and integration. Emerging market economies have gradually shifted from the peg system to more flexible arrangements, but real exchange rates have often deviated from levels properly reflecting their individual economic fundamentals.

A floating regime in conjunction with the capital account and market liberalization has been found to be able to better manage external shocks stemming from liberalized trade and capital flows with less adjustment burdens on the real sector. However, instability in the major currencies can directly subject small open economies to increased exchange rate volatility in a floating exchange rate system.

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Until their financial systems are sufficiently upgraded, the financial risks associated with exchange rate volatility will continue to undermine the economic fundamentals of emerging economies. This calls for more cooperative efforts with respect to appropriate exchange rate arrangements among key currencies - namely, the US dollar, the euro, and the Japanese yen. On a broader scale, the international community must reinforce effective coordination in macroeconomic policy at both the regional and global levels in pursuing an operational and sustainable currency stability mechanism.

Mitigating the Adverse Social Impact of Crises

James Wolfensohn, President of the World Bank Group, said the new financial architecture should be accompanied by a new development architecture for pursuing truly comprehensive growth strategies.

As crisis reform measures can exacerbate the negative consequences in unemployment, poverty and income levels, appropriate measures are needed to mitigate the social costs so that the economic turmoil does not develop into a full-blown national crisis. A country's economic development strategy must maintain proper balance between growth and social policy, as well as enhance labor market flexibility so that workers can quickly accommodate new employment opportunities. Fiscal soundness is necessary for maintaining an adequate level of social welfare, and the poor must be protected.

International financial organizations should support strengthening the social safety net in affected countries and cooperate among themselves in setting up crisis management programs. Allowing the crisis-hit country flexibility in its fiscal programs would go toward preserving social cohesion,.

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Expanding the Role of "Systematically Important Countries" in International Fora

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Given that the G-33 has proved effective as a venue for advanced and developing countries to share experiences and views, the Financial Stability Forum, which has been open to only G-7 countries, should expand its membership to include major emerging market economies. This improved representation of emer ging economies should also be reflected at various international financial institutions, including the IMF and the World Bank.

In this context, we should welcome the establishment of G-20 Forum in 1999. The G-20 Forum, whose membership includes Korea, is expected to play a productive role in further improving international financial architecture, contributing to a more stable global financial environment in the 21st century. VIP