preventing the overshooting to which exchange rates are apparently prone and might alleviate the need for a drastic reduction in domestic spending. It is a pity that Malaysia resorted to capital controls at such a late stage, when the harm had already been done. Had Dr Mahathir followed his natural inclinations immediately after the crisis broke out, and had he not frightened speculators away by his anti-Western rhetoric, we most likely would have had an ideal experiment enabling us to evaluate two competing approaches to facing a foreign-exchange crisis. So far, we can only say that the jury is still out. But even if capital controls should not prove superior to the IMF approach, it might at least turn out that there are more ways of handling a crisis than the one approved by Washington D.C.

All this does not alter the fact that it is better to prevent a crisis than to solve one. Excessive capital inflows, which stimulate spending and lead to import surpluses and relatively high prices of nontradeables (a situation represented by point A in Figure 1), should preferably be prevented. Imposing minimum capital ratios vis-à-vis foreign debts on firms and on financial institu-tions in the first place might help. Business firms would also become less vulnerable to hitches in the flow of short-term credit if they became less dependent on such credit. In South-East Asia, savings seem to flow primarily to the banks, and business firms are considerably dependent on the banks for their financing. Governments could contribute to improved financial stability by taking steps to develop their capital markets. One such step could be the introduction of funded pension systems and allowing pension funds to invest in private sector bonds and shares, following the example set by Chile.[23] That might make firms less dependent on short-term debt and thus less vulnerable to a liquidity squeeze. Another way is to grant borrowers the right to demand debt roll-overs from banks at the borrower's discretion, but at a penalty rate, as proposed by Buiter and Sibert[24] or some scheme to make banks share more of the risks of international lending. As it is now, the binary nature of capital flows, i.e. their on-or-off character, imposes unwarranted hardships on the countries hit by a sudden capital outflow.

[22] Again, the IMF fortunately is not dogmatic about this, see P. J. Quirk, O. Evans et al.: Capital Account Convertibility; Review of Experience and Implications for IMF Policies, Occasional Paper 131, IMF, Washington 1995, p. 4.

[23] G. A. Mackenzie: Reforming Latin America's Old-Age Pension Systems, in: Finance & Development, Vol. 32, No. 1, 1995; G. A. Mackenzie, P. Gerson, A. Cuevas: Pension Regimes and Saving, Occasional Paper 153, IMF, Washington 1997.

[24] W. H. Buiter, A. C. Sibert, UDROP or You Drop: A Small Contribution to the New International Financial Architecture, in: Onbeheersbare kapitaalstromen?, papers for a seminar at De Nederlandsche Bank, Amsterdam 5 March 1999.

Christa Randzio-Plath*

Do We Need a New Financial Architecture ?

The financial crises in Asia have shown the dangers resulting from globalised financial markets without an appropriate international legal and political framework. Effective regulations and supervisory mechanisms are called for.

The Janus face of globalisation has unveiled itself in the last few years. The global financial crisis has caused economic and social crises in the developing countries and slowed down growth in Europe. International movements of capital can increase world prosperity by a better allocation of capital, by lower costs for financial services and by improved risk management. The crisis made clear, however, that an inefficient, unstable and unfair global financial and monetary system can destroy the gain in prosperity within a very short time. The momentum financial markets develop by uncoupling from the real economy represents a danger. At the most 4% of world capital movements, about US dollars 1300 billion, are still linked to trade in goods and services.

* Chair of the Sub-Committee on Monetary Affairs in the European Parliament.

The remainder is looking for attractive investment possibilities. Misjudgments on financial markets expose production and services, trade and jobs to a danger which is barely controllable. To that extent, globalisation in the 21st century differs from globalisation in the age of the Silk Road.

The financial and economic crises in Japan and South-East Asia, in Russia and in Latin America have cost hundreds of billions of US dollars and destroyed over 24 million jobs, particularly in emerging economies. The impact of these crises is becoming increasingly distinct in Europe. Contrary to the European Council and the European Commission, the European Parliament has warned repeatedly against underestimating the impact of the crises and called for a European plan of action for investment, growth and employment, with innovative measures to the European infrastructure by means of public-private partnerships. In its forecasts of spring 1999, the European Commission finally noted that the crises negatively affect exports and growth rates in Europe.

International financial and currency stability is needed for growth and prosperity. In the age of globalisation, a new financial architecture is therefore required. The crises in Asia show the dangers brought about by globalised markets, if globalisation is realised without an appropriate international legal and political framework and without consideration of its social dimension. Especially in emerging and transforming economies, globalised financial markets encounter structures in the financial sector and supervision which are not sufficiently prepared for the complete liberalisation of capital movements. Transparency as well as enhanced supervision of banks and non-banks, stronger international institutions and clearer rules are needed.

The International Dimension of the Euro

The introduction of the euro changes the world monetary system. The euro will not remain an internal market currency, but will also gain in importance as an international currency. So far about 65% of foreign exchange reserves are held in US dollars and about 50% of world trade is invoiced in US dollars. With the beginning of the monetary union, however, a new world reserve and world trade currency has appeared, which will play an important role next to the US dollar. In addition, a uniform euro financial market will attract foreign and European investments, which are urgently needed in the European Union to activate job-creating growth.

There are now three large economic and currency areas which depend to a certain extent on the relationship between their currencies: the US dollar, the euro and the yen. With globalised markets, the world economy is organising itself into large economic regions, each of which works well with one currency. The euro can contribute to world-wide stability given that a system of equally strong world currencies provides a better chance of stability than if a single currency such as the US dollar dominates. The relationships between the three main currencies have to be clearly defined, however. International economic developments and interests now make target zones for exchange rates an unlikely solution. Nevertheless, a tri-polar monetary system can also contribute towards monetary stabilisation, which would be positive both for growth and employment and for financial markets. The USA and the EU have a special responsibility for overcoming the financial and economic crises. There therefore has to be close cooperation between the Euro-11-zone and the US institutions. Decisions on exchange-rate policies must be subject to joint debate.

Monetary union offers the opportunity to regain the sovereignty and control which the nation states have lost. This must be supported by a stronger international role for the European Union. Seen from the institutional point of view, the ECB is very rightly represented at meetings of the IMF and the BIS, and at G-7 and G-10 summits. In addition to that, however, the Euro-11-zone has to be represented by the chair of the Euro-11-Council and the European Commission as an integrational factor. Other solutions are not justifiable in a democracy. In the long run, the EU member states must leave their representation to the European institutions, as Europe will weaken if it does not speak with one voice.

The globalisation of the financial markets requires a new regulatory framework. The global financial markets have experienced quantum leaps both quantitatively and qualitatively. They are growing rapidly without effective regulations or appropriate supervision mechanisms. Therefore, the European Parliament calls for transparency, regulation and supervision within the framework of international cooperation, with the following focal points:

☐ an efficient world financial system, the limitation of short-term capital inflows, complete transparency of financial data, a global financial regulatory framework, international standards and strengthening of the IMF;

☐ a stable world financial system which includes the private sector by giving it an active financial role in preventing as well as solving crises, which provides efficient instruments at the national level and creates close international economic and monetary collaboration;

☐ a fair world financial system, which includes the social dimension in crisis management, contributes to debt reduction and debt restructuring and promotes appropriate social and ecological minimum standards.

Demands of the European Parliament

The European Parliament therefore calls for a set of rules which increases the transparency of financial markets operations, codes of conduct which are widely accepted, the stricter supervision of these rules and concrete international cooperation.

On the basis of international standards complete transparency of capital inflows and outflows is to be ensured and standardised financial data are to be published regularly. An assessment of the capital adequacy ratio in banking systems is required as well as improvements in the regulatory standards for the control of financial markets, standards which have been judged insufficient by the BIS itself. A European framework for these reforms must be implemented in the context of the Cardiff II process, European financial services and the single market.

Within the EU, a common minimum standard for guarantees, risk management criteria and procedures for banks and non-banks is needed, including a memorandum of understanding for the cooperation and coordination between the different supervisory authorities, the institutionalisation of the immediate provision of liquidity to the markets, lender-of-last-resort functions as well as a reform of financial regulations within the context of the GATS.

An enhanced monitoring role to promote greater transparency of market operations is to be implemented, especially concerning data dissemination standards on financial information. This transparency should encompass both the advanced and emerging financial markets and must include trading in securities, especially high risk financial instruments such as derivatives as well as data on the solvency to risk-weighted assets ratio according to the Basle agreement, which is currently not being respected.

The proposals by the international financial institutions for codes of conduct in the fields of transparency of monetary and financial policy and corporate governance as well as the IMF Code on Fiscal Transparency must be applied. EU Member States are requested to accept regular surveillance of the application of these codes in the form of a Financial Review Mechanism, with the publication of the results in annual reports. For improved transparency in the corporate sector a Code of Good Practice on Corporate Governance is recommended, as crises can arise as a result of private sector imbalances and poor corporate governance.

These codes of conduct must introduce procedures which ensure the effective implementation of, and related enforcement mechanisms for, the transparency of financial data, for both the borrower and the lender, through the introduction of statutory procedures which oblige the private sector to publish standardised data to allow the enforcement of these codes of conduct.

These codes must be extended to include the qualifications of financial traders and an ethical code of conduct on their behaviour.

International rating agencies should take part in the preparation of these codes of conduct, as they have a crucial role to play in ensuring transparency and bringing credibility to the procedures.

Banking supervision on a world-wide level is needed. Above all, however, standards of prudential supervision practices are needed at the European level. Such prudential supervision should include not only credit institutions and other financial institutions, but also private enterprises which act, through their activities on financial markets, as *de facto* financial institutions. The Maastricht Treaty did not rule out the question of banking supervision within Economic and Monetary Union. In a single currency area, risks on financial markets must be reduced by uniform rules. A Statement of Intent for the harmonisation of prudential supervision based on Article 105(6) of the Maastricht Treaty is therefore appropriate. Therefore, a supplementary protocol is needed for the Maastricht Treaty.

In order to avoid the moral hazard problem, a new approach is required, which binds the private sector through its active financial participation in the preventing and solving of crises, as has already been undertaken within the framework of the South Korea-IMF Agreement. It therefore requires credible regional consultation mechanisms including the pooling of private and public funds for emergency packages which bring together the IMF and private institutions

as joint lenders to crisis-hit countries. IMF credits should only be assigned if the private sector shares the risks.

Within the framework of global financial markets, capital controls do not offer a long-term solution for capital outflows from crisis-hit countries, as they encourage domestic evasion and capital flight and discourage foreign investors. However, certain circumstances can make short-term controls necessary at the national level. It would be worth considering a time-framed 'financial safeguard clause' as quickly as possible, which can be achieved at the international level on the basis of the IMF statute. This is to be implemented together with a standstill procedure on debt servicing for countries hit by a financial crisis as allowed for under Article VII of the IMF's Articles of Association, which would allow the country enough time to design a debt reorganisation plan. Crisis prevention, however, must also play a significant role in the future reform plans of the IMF.

The Reform of the Bretton Woods Institutions

The world financial crises have shown that there is a need to reform the international monetary system and especially the IMF. The Bretton Woods institutions are now more than 55 years old. They were established for a world of fixed exchange rates and capital controls, when international capital flows were much smaller. The political accountability of the International Monetary Fund needs to be increased by transforming the Interim Committee into a political 'Council' with decision-making rather than consultative powers, as provided for by Article XII Section I of the Articles of Agreement. Thus an advisory body would be created, whose members would be collectively responsible for key developments in the international monetary and financial system.

IMF programmes must avoid the danger of speculators' 'bailing-out'. Since the crisis in Mexico in the middle of the 1990s, private investors have relied on the expectation that the IMF would bail them out if there were a liquidity crisis in any given country. Because of that, investors have tended not to take proper account of the costs associated with risk-taking. This typically led to overly risky behaviour by the private sector. A system must be found which strikes the right balance between sufficient liquidity assistance and market discipline. Moral hazard will only be minimised if there is a reasonable possibility of failure and if there are appropriate loss-sharing rules. Dangers also exist beyond that if protectionist measures for capital movements or trading are introduced as a solution to economic and financial problems.

Proposals for the improved operation of the international economic and financial system must be submitted. Creating an 'Economic Security Council' under the umbrella of the United Nations would allow for a more balanced approach between the interests of the developed or rich nations and the poorer and indebted nations in these policy areas. Both trade and financial services have to be included in a new round of WTO negotiations to help prevent distortions in world trade.

Greater transparency and modernised financial markets seem to be the key remedies to the current system's shortcomings. Hence, the establishment of a 'Standing Committee on global financial stability' has been suggested. It is meant to solve the challenge of enforcing and monitoring posed by the underlying objectives. In the meantime, the G-7 decided that the Standing Committee can be summoned on their initiative. It is to hold regular meetings in order to recognise problems and abortive developments of the international financial system and to report these to the G-7 finance ministers and central bank governors. The forum is to consist of representatives of treasuries, central banks and banking supervision institutions as well as representatives of the international financial institutions, and be supported by a small secretariat. The committee may be useful. However, it cannot replace a political revaluation of the IMF advisory body.

The crises in other regions of the world have shown the risk potentials of financial markets, which operate globally 24 hours a day. The global dimension becomes clear by looking at the speed at which financial markets grow: national financial markets grow 10% per annum on average, off-shore centres 30%, thanks to globalisation, deregulation and the decreasing institutionalisation of financial markets. Globalisation needs ruling, and rules need to be global. This applies to international financial organisations just as to governments and parliaments. We need more multi-polar relations, more democracy and solidarity and a 'new deal' for sustainable job-creating growth world-wide. A new world financial architecture must contribute to the process. The international framework has to be adapted to the globalisation of the markets, and international co-operation in macro-economic policies has to be improved in order to overcome the menace of instable financial markets.