■ international financial architecture

The international financial architecture is the set of institutions and norms—both international and domestic—that shape the international financial system. The institutional relations among industrial economies are clearly part of the international financial architecture. The policy debate that followed the currency crises in Asia and other emerging market crises in the late 1990s focused on reforms that could help make the integration of emerging economies into the international financial system less disruptive.

The resulting debate rested on two assumptions. First, private capital should normally flow from advanced economies to emerging economies—at least to those with sound economic fundamentals and solid policy frameworks. Second, the integration of emerging economies into global financial markets—a process that was catalyzed by the 1989–90 Brady plan, which transformed bad loans left over from the 1980s debt crisis into bonds—had not proceeded as smoothly as many had hoped. The "architects" consequently sought to create an institutional structure that would sustain private financial flows to emerging economies while reducing the risk that sudden interruptions in these flows would lead to painful crises and also increasing the international community's ability to manage crises that could not be avoided.

Background U.S. treasury secretary Robert Rubin first used the term *international financial architecture* in a speech in April 1998. The resulting debate culminated in the Cologne communiqué in 1999. It emphasized the need for a higher standard of transparency, stronger financial systems in emerging economies, changes in financial regulation in industrial economies to help make capital flows less cyclical, "corner" exchange rate regimes, and greater efforts to involve private creditors in the provision of crisis financing. This agenda informed much of the work of the International Monetary Fund (IMF) over the next few years.

It would be a mistake, however, to limit analysis of the architecture reforms solely to the specific proposals that followed from Rubin's speech: the debate over the need to reform the international financial architecture started well before Rubin coined the term *architecture* and did not end when the term disappeared from the official sector's formal lexicon in 2001. After Mexico's crisis of 1994–95, the Group of Seven (G7) called for the development of new facilities designed to allow the IMF to lend larger sums, but for shorter periods and at higher rates, as well an expansion of the IMF's lending capacity. These reforms were implemented in 1997 and 1998 with the creation of the Supplemental Reserve Facility and congressional approval of an IMF quota increase. The substantive debate over many key issues continued through 2003, when Mexico's decision to introduce collective action clauses (CACs)—provisions that allowed a supermajority of bondholders to amend a bond's financial terms—ended the debate over IMF's proposal for a new international sovereign bankruptcy regime. The intensity of the debate over the right scale of IMF lending waned in the absence of any major crises. New topics, notably a surge in the U.S. current account deficit largely financed by a rise in the current account surplus of the emerging world, moved to the top of the international economic and financial policy agenda.

During the peak of the debate over financial crises in emerging economies, many complained that talk of architecture was too grand and that "plumbing" would be a more appropriate metaphor. Such arguments came from two directions: those who thought better plumbing was all that the international financial system needed, and those who thought the G7 was making a mistake by just fiddling with the plumbing when a truly new architecture was needed.

Ambitious Proposals The Asian crisis certainly generated a host of ambitious proposals. The IMF's first deputy managing director Anne Krueger proposed radically changing the institutions for debt restructuring by amending the IMF's Articles of Agreement to provide sovereign governments in default with bankruptcy-style protections (the sovereign debt restructuring mechanism, or SDRM). The economist Joseph Stiglitz suggested a "super" Chapter 11 regime to facilitate an across-the-board restructuring of private borrowers' debts in the event of macroeconomic shocks.

Anne Krueger's predecessor, Stanley Fischer, focused more on the institutional structure for crisis lending than on the institutional structure for debt restructuring. Fischer argued that the IMF should be transformed into a lender of last resort, able to lend in quantities that would be sure to end cross-border runs. The International Financial Institutions Advisory Committee (2000), more commonly called the Meltzer Commission, suggested that the IMF get out of the business of lending to countries that promise to deliver sound macroeconomic policies only when they are close to default and instead lend large sums to countries that qualified in advance for extra protection by maintaining good policies. The International Financial Institutions Advisory Committee (IFIAC) specifically recommended that the IMF lend large sums for short-term loans—120 days with only one possible rollover—to countries that prequalified for support. The IFIAC also suggested that the strength of a country's banking system be the key criterion for determining eligibility. Others have proposed less draconian forms of prequalification.

Proposed changes in governance of the major international financial institutions were equally dramatic, with proposals tabled to merge the IMF and the World Bank, to eliminate both institutions, and to create a new global financial regulator.

More Modest Results In the end, calls for major reforms generally were rejected in favor of more incremental changes. The IMF toyed with a facility based on prequalification (the contingent credit line, or CCL) but never gave up its traditional crisis lending. A new forum that brought regulators together with finance ministries, central banks, and the IMF (the Financial Stability Forum) and the development of new international codes and standards substituted for the creation of an international superregulator. No major reforms were made to the IMF's voting structure after the Asian crisis—though in 2006, the IMF did increase the quota of four underrepresented emerging economies: China, Korea, Mexico, and Turkey. The membership of informal clubs such as the G7 that often influenced IMF policy did not change, but a new forum, the G20, was created to bring the G7 together with major emerging markets.

Modest Reforms In the end, though, the architects did more than just clean up the plumbing. Some of the most consequential changes were adopted early on. After the crisis in Mexico, the United States decided to strengthen multilateral institutions for crisis financing. This led, in time, to important changes in the architecture. A bigger IMF was combined with facilities designed to allow the IMF to put more money on the table faster. In principle, exceptional IMF financing came with an expectation that those funds could be repaid more quickly than a typical IMF loan. In practice, the IMF's major shareholders did lend large sums to some countries that did not have a realistic chance of repaying the fund quickly; the large short-term loans provided to Turkey, Brazil, and Argentina in 2001 and 2002 all had to be refinanced. Large-scale crisis financing from the IMF effectively became the norm—despite claims by the G7 to the contrary—when major emerging economies encountered financial difficulties.

The institutions for debt restructuring evolved organically. The large international banks generally stopped providing medium- to long-term syndicated loans to the governments of emerging economies after the debt crisis of the 1980s, instead lending for shorter terms to private banks (some of which then lent to their local government) or private firms. Nonetheless, the architecture for coordinating the major international banks that was inherited from the sovereign debt crisis of the 1980s was adapted in Korea to help coordinate a rescheduling of interbank credit lines. New institutions for bond restructuring emerged, though not without some birth pangs. Negotiations between a distressed sovereign borrower and a coordinating committee of banks gave way to exchange offers. Distressed debtors, often advised by a major international bank, offered to exchange old bonds for new bonds with different payment terms. The success of these exchanges—participation was high and litigation proved less troublesome than initially anticipated—eliminated much of the pressure for more dramatic changes to the institutions for debt restructuring.

Arguably of most importance, the policies of most of the world's emerging economies changed dramatically. Emerging market economies embraced central bank independence and inflation targeting. Indeed, their inflation rates began to converge with those of the advanced countries. Local currency bond markets took off. Emerging economies concluded that they needed to hold far more reserves than they had held in the past; most now hold reserves well in excess of their short-term external debts. Many emerging economies began to allow their exchange rate to float, though most still intervene far more heavily than advanced economies. Transparency increased dramatically—at least for those emerging economies that felt compelled to live up to the IMF's revised standards.

Compared to the changes made in emerging markets, the changes in regulatory structure in industrial economies were quite modest. Concerns that capital flows from the industrial world to emerging economies were procyclical, with too much money flowing into emerging economies in good times and too much flowing out in bad times, did not prompt major policy changes. A revised set of Basel capital standards was in the process of being implemented as of 2007. Although hedge funds and the regulators of the banks that provide hedge funds with leverage were temporarily chastened by the 1998 implosion of a major U.S. hedge fund, Long-term Capital Management, the formal regulatory structure changed little. After a brief down period, hedge funds entered a new phase of phenomenal growth.

The debate on architecture ended with a broad consensus on the steps emerging economies needed to take to reduce the probability of crises, but with few tools that could force an emerging economy to follow these recommendations. A comparable consensus on the core issue of crisis resolution never truly emerged. The G7 was comfortable with an IMF that had the capacity to make big loans, and policy statements that claimed—without much credibility—that this capacity would not be used in the future. The G7—and for that matter the world's major emerging economies—never could define when a debt restructuring should be an integral part of efforts to resolve a crisis.

Changes in the global economy, though, gradually shifted the focus of policy markets away from emerging market crises and reduced the pressure to find real consensus on difficult issues. Worries about too much demand for IMF lending gave way to concerns that the IMF might earn too little from its lending to cover its expenses. Concerns that the IMF was too reluctant to criticize emerging economies that clung too tenaciously to exchange rate pegs in the face of current account deficits gave way to concerns that the IMF was too reluctant to criticize emerging economies that intervened heavily to maintain undervalued exchange rates. Concerns that emerging economies had too few reserves gave way to concerns that they held too many—and were adding even more every year.

By 2005, private capital flows to emerging economies matched their pre–Asian crisis peak. Eastern Europe, in part because of its institutional tie to the rest of Europe, relied on these capital inflows to cover significant current account deficits. But most other emerging economies used this surge in private capital flows, along with the windfall from rising commodity prices, to add to their reserves. In aggregate, the emerging world ran a large current account surplus, financing deficits in many of the world's advanced economies. This system, which has been labeled a new Bretton Woods system, represented a real change in the international financial architecture, even if it did not emerge from the debate that occupied policymakers in the 1990s, let alone a new Bretton Woods conference.

The debate over the architecture for managing financial crises in emerging economies has been superseded by a different architecture debate focused on finding new ways to facilitate macroeconomic policy coordination between the world's new creditor countries and its major debtor countries to help reduce global imbalances. This debate covers a very different set of topics than the previous debate—from the optimal use of emerging economies' vast reserves to strengthening the IMF's surveillance of surplus countries in the emerging world and deficit countries in the G7. One topic, though, has stayed constant: the continuing need to adapt the international financial world's governing institutions, both formal and informal, to better reflect the growing role emerging economies play in the international financial system.

Also see bail-ins; bailouts; banking crisis; Bretton Woods system; capital flows to developing countries; currency crisis; exchange rate regimes; financial crisis; global imbalances; hedge funds; hot money and sudden stops; inflation targeting; International Monetary Fund (IMF); International Monetary Fund conditionality; International Monetary Fund surveillance; international policy coordination; international reserves; Latin American debt crisis; lender of last resort; original sin; twin deficits

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BRAD SETSER

■ international financial centers

International financial centers (IFCs) are global hubs for banking, insurance, capital, money, and foreign exchange transactions. A large share of global trade and management of financial wealth and debt instruments is conducted in these centers. By virtue of the volume of transactions and the depth of their markets, they are leaders in setting the price of financial instruments. Such instruments are used to channel (intermediate) capital between savers and borrowers and to transfer financial risk.

The predominant IFCs are London and New York. Other key centers include Tokyo and Frankfurt. A number of financial centers are important in a regional context, including Singapore and Hong Kong. Offshore financial centers are important domiciles for international financial transactions with the pricing and trading of the financial instruments keyed off the markets in the major IFCs. The term *international financial center* is also used as a signal by some centers that a preferential tax and/or flexible regulatory regime will apply to financial entities/transactions domiciled there. Competition among the financial centers is intense, and successful centers offer comparative advantage for market participants.