Understanding and Reforming the Global Financial Architecture in New Era

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Abstract
The 1990s have seen a spate of currency and financial crises affecting emerging-market countries, the frequency and severity of which have raised serious doubts about the stability of financial markets facing these countries as they open their economies and integrate with the rest of the world. This in turn has sparked the search for a new financial architecture which would reduce the degree of instability in the system and improve its capacity to handle instability when it arises. This paper will focus on suggesting some measures to develop a new and effective financial architecture.

Keywords
Financial Crisis, Financial Markets, Financial Architecture

I. Introduction
The 1990s have seen a spate of currency and financial crises affecting emerging-market countries, the frequency and severity of which have raised serious doubts about the stability of financial markets facing these countries as they open their economies and integrate with the rest of the world. This in turn has sparked the search for a new financial architecture which would reduce the degree of instability in the system and improve its capacity to handle instability when it arises.

Recognition of the potential instability in the system was slow in coming, despite early warnings. The ERM (Exchange Rate Mechanism) crisis of 1992 was a pointer to what lay ahead, but it did not generate calls for systemic reforms because it was primarily a currency crisis and the industrialized countries affected did not experience a generalized financial crisis with disruptive effects on the real economy. Two years later, when the fiftieth anniversary of the Bretton Woods Agreement was celebrated and the functioning of the international financial system was subjected to in-depth examination, there was relatively little concern about instability.

The developing countries raised familiar concerns about the system’s inability to assure an adequate flow of resources for development and structural adjustment, but the dominant view among industrialized countries was that the system was functioning well and no major changes were needed. The urgency to put a new architecture in place increased sharply after the collapse of Long Term Capital Management (LTCM). The frequency and severity of financial crises in the 1990s prompted the search for a new financial architecture.

II. Nature of Contemporary Crisis
Contemporary crises differ from traditional episodes of balance of payments problems in important respects. The latter typically originated in the current account, with a macro-economic policy imbalance, or an external shock or domestic supply shock leading to a widening of the current account deficit which needed to be financed. Contemporary crises, on the other hand, originate from the capital account and are caused by a loss of confidence, which leads to a large outflow of capital and a denial of access to new financing. Contemporary crises are not only difficult to predict, they are also difficult to manage for two reasons: they explode quite suddenly, leaving very little time for the authorities to react, and the financing gap associated with them is very large. For the present, we will only note that the most important objective in handling a crisis of confidence is to try to restore confidence, so that capital flows return to normal levels. However, confidence once lost is not easily regained. Fiscal and monetary policies take time to have effect and in a world in which capital can move as rapidly as it does today, a great deal of damage can be done before the crisis resolution strategy begins to take hold.

III. Why Developing Countries are More Vulnerable
The frequency of crises affecting emerging markets in the 1990s is sometimes attributed to the high volatility of private capital in international financial markets, but this is not by itself a sufficient explanation since industrialized countries face the same capital markets, but they have not faced crises of similar severity. Developing countries clearly have special characteristics which make them more vulnerable and these characteristics have to be kept in mind in devising mechanisms for crisis prevention and crisis resolution in the new global architecture. Some of the features which make developing countries especially vulnerable to severe crises are the following:

A. Lack of information
Investors have much less information about conditions in developing countries than about industrialized countries and this creates potential instability. Investment flows which are initially based on inadequate information are more liable to change based on new information or perceptions which may not be very robust. Lack of information also leads to herd behaviour, with less informed investors simply following the lead of those who are supposed to know better, creating familiar boom-bust cycles. The practice of judging performance of individual fund managers relative to others makes it optimal for individual fund managers to move with the herd unless they have significantly better information which tells them to do otherwise.

B. Contagion
Contagion is a new phenomenon of the 1990s to which developing countries are particularly vulnerable. A loss of confidence in one country, which may be objectively justifiable in terms of deteriorating fundamentals, leads to a loss of confidence in another country purely through contagion, even though the fundamentals in the second country are quite sound. This phenomenon can be explained in terms of the inadequacy of the information needed for investors as a group to discriminate between countries. The expected behaviour of the group can be a determining factor even for the well-informed investor aware of the soundness of fundamentals since it will be rational to exit if other investors as a group are expected to panic and this is likely to affect the market.
C. Thin Markets
The thinness of developing country markets relative to the size of global capital flows makes developing countries more vulnerable because changes in capital flows, which are relatively small measured by global standards, can cause large changes in asset prices. This generates euphoria in good times, as rising asset prices appear to validate the expectations underlying initial inflows, but it also produces panics in bad times. The nervousness about the de-stabilizing capability of hedge funds arises precisely because of the perception that these funds can mobilize resources that are relatively large compared to the thin markets in developing countries, making it easier for them to destabilize these markets.

D. Financial Sector Weakness
Weaknesses in the financial sector, especially in banks, have emerged as one of the most important causes of financial crises. With a weak banking system, capital inflows in the boom phase are likely to be intermediated in an imprudent manner, leading to an excessive build-up of foreign exchange exposure and of short-term foreign debt, either by the banks themselves (for example, Thailand and Korea) or by corporate borrowers (for example, Indonesia).

E. Exchange Rate Regimes
The ‘soft-peg’ exchange rate regimes adopted by many developing countries are widely regarded as having contributed to vulnerability. This is because they give the appearance of a firm commitment to maintain exchange rate stability, which encourages borrowers to ignore exchange risk and build up substantial unhedged foreign exchange exposure.

F. Implicit Guarantees
Many developing countries operate within an institutional framework which is seen by investors as offering ‘implicit guarantees’ which are then said to encourage imprudent lending to these countries, leading to excessive inflows which make them more vulnerable to crises. Public sector banks and large public sector corporations are often seen to have implicit government guarantees.

G. Political Factors
Political uncertainty is not unique to developing countries but it has a more damaging effect on investor perceptions when it occurs in developing countries than in industrialized countries because it is generally seen as signaling a possible deterioration in economic management. It is interesting to note that many of the recent crises were associated with periods of political uncertainty.

IV. Crisis Prevention Measures in the New Architecture
The time-worn maxim that an ounce of prevention is worth a pound of cure is especially applicable to financial crises because the costs of managing such crises once they occur are very high compared to the cost of trying to avoid them. This is especially so if the impact of crises on the welfare of the poor is taken into account. The new architecture measures have focused on six critical areas of crisis prevention. These are:
1. Improving macro-economic management;
2. Increasing availability of information and strengthening surveillance;
3. Strengthening the financial system in developing countries;
4. International action to strengthen the financial system;
5. Exchange rate regimes;
6. Policies towards capital controls.

IV. Improving Macro-Economic Management
The least controversial prescription for crisis prevention - the equivalent of ‘motherhood’ and ‘apple pie’ - is that countries should pursue sound macro-economic policies. These policies are obviously important in themselves because they determine economic performance. They also represent the so-called ‘macro-economic fundamentals’ on which knowledgeable investors assess prospects for the economy, which in turn determines investor perceptions. The establishment of sound fundamentals must therefore be the first requirement for any crisis prevention strategy.

An important lesson from the experience of recent crises is that the soundness of macro-economic fundamentals has to be assessed on the basis of indicators which go beyond the traditional areas of fiscal and monetary policy.

V. Increasing Availability of Information and Strengthening Surveillance
Since lack of information is one of the factors which makes developing countries vulnerable to euphoria, panic and contagion, anything that improves the quality of information can be expected to contribute to greater stability. The new architecture focuses on the need to increase the volume, quality and transparency of information available to markets.

VI. Strengthening the Financial Sector in Developing Countries
Efforts to strengthen the financial system have a major role in crisis prevention. The current consensus is in favour of casting the net very wide to cover not only the banking system, but also the other major segments of the financial system, such as the securities market and insurance, as well as the institutional infrastructure supporting the financial sector, i.e. accounting systems, bankruptcy laws and corporate governance. There is general agreement that regulatory standards and practices prevailing in developing countries fall short of international norms in all these areas and should be upgraded.

VII. International Action to Strengthen Financial Systems
Action by developing countries to strengthen their domestic financial system can be supplemented by action at the international level which will discourage behaviour which increases potential instability. Several initiatives have been identified in this context.
1. Banking regulations in industrialized countries
2. Regulation of hedge funds
3. The role of the IMF and the World Bank
4. The Financial Stability Forum

VIII. The Choice of Exchange Rate Regime
Since the exchange rate polities followed by some of the Asian countries were widely held to have contributed to the crisis in that region, the choice of exchange rate regime is regarded as one of the critical elements of crisis prevention in the new architecture. An often quoted formula is that ‘soft-peg’ exchange rates -i.e. exchange rates that appear to be fixed but where there is no credible institutional assurance of fixity - are prone to generate crises and must be avoided. Developing countries must therefore choose
between two polar extremes of a fully flexible exchange rate or a genuinely fixed exchange rate based on a credible institutional arrangement which ensures fixity, such as a currency hoard, or even outright dollarization.

**IX. Control Over Capital Movements**

An area in which differences persist is the role of controls over capital movements in preventing crises. Before the East Asian crisis, developing countries were generally encouraged by the IMF to liberalize restrictions on capital movements as a logical extension of market-oriented reforms, which would enable them to gain access to international capital and also improve the efficiency of resource allocation. Following the crisis in East Asia, there is much greater recognition that liberalization of capital movements can subject developing countries to the risk of destabilizing capital outflows, especially in situations where there are macro-economic imbalances and/or the financial sector is weak. This raises the issue of whether developing countries should retain some control over capital movements as a crisis prevention measure.

**X. Conclusion**

The measures suggested above are not a blue print for an entirely new architecture, but a set of proposals to fill gaps in the existing system and strengthen it in places. However, as pointed out in the introduction, the incremental nature of the changes envisaged is not necessarily a shortcoming. The critical question is whether these changes will achieve the objective of imparting greater stability to international financial markets, especially from the perspective of emerging market economies.

Collective responsibility, political ownership and greater participation by developing countries in the critical forums which are seen to give broad directions to the world economy are essential if we want to develop ownership of, and commitment to, these changes in the developing world. Globalization and integration are most likely to succeed if they are seen to be supported by international institutions which ensure a high degree of partnership.

The absence of such institutions is an important missing element in international institutions which ensure a high degree of partnership. A genuinely fixed exchange rate based on a credible institutional arrangement which ensures fixity, such as a currency hoard, or even outright dollarization.

**References**


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Dr. Jaskaran Singh Dhillon is post graduate in Management. He has done his doctorate from HNB Garhwal Central University, Srinagar, Uttrakhand. He has vast experience of industry and academia and is into teaching for sixteen years. He has published five research books and various research articles in various national and international journals of repute. He has attended many conferences/ Seminars/ Symposium/ workshops etc. at national and international level.

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