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Towards a global financial architecture: capital mobility and risk management issues

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Abstract

In recent years, we have witnessed a significant loss of national welfare from economic crises resulting from the weakness of the global financial system. After analyzing the root causes of this experience, we focus on two major fault lines that have characterized most of these occurrences: First, we review the arguments in favor of and against the open capital markets paradigm. We identify factors that must be taken into account for a successful integration of the national economies in the global capital market. Second, we discuss the lack of attention to innovations in risk management practices, which deal with the new sources of risk inherent in an increasingly integrated and complex global economy. Finally, we suggest some desirable democratic features and the importance of recognizing national architectures in the design of a new global financial architecture. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The history of global finance is replete with economic and financial crises. For example, the May 1998 World Economic Outlook, Chapter IV has identified 158

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episodes of currency crises and 54 episodes of banking crises between 1975 and 1997. During the 1990s, we witnessed the European monetary crises of 1992–1993, the Mexican crisis of 1994 and the most recent East Asian followed by the Russian and the Brazilian crisis. Indeed, the financial crises are not unique to the current international system or the emerging economies.

Although, the economic and financial costs of such episodes have led to frequent changes in the national and global financial architecture, the recent crises have been severe in terms of their spillover effects, social costs and human suffering, and require a significantly bolder approach.[1] In this respect, a number of proposals have been put forward by academics, policy makers and financial institutions ranging from a major overhaul to a totally new system. Although well-meaning and substantial, most of these proposals will fall short of achieving their stated goals of reducing the probability of future crises and/or more effective handling of crises that do (will) occur. The primary reasons include: the need for a closure on the sensitive issue of international capital flows; the appropriate implementation of risk management technologies; insufficient recognition of (the difficult to quantify) social costs; and the need to understand and accommodate the national financial architectures in the overarching global financial architecture.

Hence, the purpose of this paper is to complement and augment the existing proposals towards a more desirable global financial architecture. Our primary focus is on issues that are not adequately dealt with in the existing literature since it would not be very useful to discuss issues on which a wide consensus already exists.

The paper begins with a brief overview of the recent crisis and its major causes. Section 2 reviews the salient components of the proposed reforms of the system. Section 3 contributes towards a closure on the issue of capital flows. It will review the arguments in favor and against the open capital markets paradigm and identify the factors that must be taken into account for a successful integration of the national economies in the global capital market. Section 4 discusses the challenges to current risk management practices posed by liberalized capital flows. Section 5 proposes the establishment of a more democratic system that would address the well-being of the silent majorities that have disproportionately borne the burden of the crises that were not of their own making. The paper concludes with a discussion of the importance of recognizing national architectures in the design of global financial architecture.

2. Overview of the East Asian crisis

The East Asian crisis was extremely serious. Not only was it a combination of currency and banking crises, it quickly led to a debt (internal and external) crisis

[1] Many of the national financial innovations, e.g. deposit insurance, role of the central bank as lender of last resort as well as the international institutions such as the IMF, IBRD and the regional development banks were formed in response to past episodes and to avert potential future crises.