

Towards a new international financial system?

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Resumo

As crises financeiras e monetárias recentes suscitaram debates com respeito à criação de um novo sistema financeiro internacional, a fim de aprimorar o funcionamento dos mercados financeiros e evitar distúrbios, através de regulações e instrumentos de supervisão em nível internacional. Neste artigo, apresentamos e avaliamos os mais recentes e importantes relatórios e normas emitidas por agências multilaterais, tais quais FMI, IOSCO, Banco Mundial, BIS e FSF. Afirmamos que, no presente, não há nenhuma potência hegemônica capaz ou empenhada na criação de um sistema financeiro e monetário baseado em princípios como o controle de capitais. As propostas prevaletentes para uma arquitetura financeira têm no mercado seu instrumento de regulação, o que pode ser incapaz de abrandar graves crises financeiras e monetárias.

Palavras-chave

Sistema financeiro internacional; estabilidade hegemônica; regulação.

Abstract

Recent financial and currency crises have given rise to debates regarding the creation of a new international financial system designed to enhance the functioning of financial markets and avoid turmoil, by improving regulations and surveillance instruments on an international basis. In this paper, we present and assess the latest and most important reports, standards, and guidelines issued by multilateral agencies such as IMF, IOSCO, World Bank, BIS and FSF.

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We argue, that at present, there is no evident hegemonic power capable or willing to impose a new international financial and monetary system based on principles of capital controls. The prevailing proposals for a more regulated financial architecture established a market-based approach, which may not be able to mitigate severe financial and monetary crises.

Key words

International financial system; hegemonic stability; regulation.

Classificação JEL: F33, F02, G28.

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1 - Introduction

The financial liberalization and capital movements have had rapid growth since the early 1970s, after the demise of the Bretton Woods system. Consequently, the establishment of a worldwide financial integration, in a flexible exchange rate regime, led to a notable instability on financial markets. More recently, in the 1990s, the sequence of financial and currency crisis in emerging economies and their contagion effects to developed countries¹ gave rise to debates regarding the creation of a new international financial system, designed to enhance the functioning of financial markets and avoid turmoils by improving regulations and surveillance instruments on an international basis.

In this paper we present and assess the latest and most relevant reports, standards, and guidelines issued by multilateral agencies such as the

¹ For example, the bankruptcy in 1998 of the Long Term Capital Management, a hedge fund which bet aggressively on declining spreads for emerging markets.

International Monetary Fund (IMF), International Organization of Securities Commissions (IOSCO), World Bank, Basel Committee on Banking Supervision (BCBS) and Financial Stability Forum (FSF). Our purpose is not to scrutinize each document, since the literature is vast, but to offer an overview of the reasoning behind the financial system reform.

However, in our opinion, to proceed with the analysis of the determinants of the international financial system in a strict economic outlook would convey an unsatisfactory outcome, since history and politics matter in international economic relations. So we shall incorporate political economy's theories, such as the theory of hegemonic stability, in our analysis to address the development (or not) of a new international financial architecture.

2 - What is crisis?

Economic crises can be disguised in different configurations and extensions. They may involve overproduction and overcapacity crises, or a slowed growth of demand that would cause a drop in the investment rate and a fall in profits that creates pressure on inflation as means of counter-attacking the higher production costs, which ultimately entails situations of economic depression or stagnation. Apart from that, an economic downturn may also be manifested in major devaluations, credit retreat, massive withdrawals and banking bankruptcy, which keep a close relationship with currency markets and financial sectors' activities.

There is no broadly accepted definition on currency crises. Nevertheless, in their very basis, there is an inner circular logic where investors flee from a currency because they expect its devaluation, and then the resulting capital outflows strengthen the pressure on the devaluation (Krugman, 2001). At present, the liberalized economic environment throughout the world made the currency markets intrinsically connected to financial markets, and so does the crises. The link between currency and financial crisis is so strong that some authors refer to them as **twin crises** (Canuto; Curado, 2001; Kaminsky; Reinhart, 1999).

In the 1990s, different from previous currency crises, the macroeconomic fundamentals were not unfavorable (according to first and second generation models), for instance, the Asian crisis was not preceded by overly expansionary policies. But currency crises are not all alike; some crises may have a predictable component, whereas others are difficult to interpret exclusively on the basis of fundamentals (Flood; Marion, 1998). Though, even being hard

to indicate events that may trigger a crisis, the lack of confidence of market agents (e.g. in a currency or in a stock price) is a common element. Thus, an absolute uncertainty on the economy may lead to panic, and panics can quickly shatter the confidence of market operators in the safety of cross-border transactions, and destroy international financial markets. In particular, during international financial crises, private financial operators tend to retreat to the safety of domestic markets because of lesser familiarity with foreign markets, the currency risks involved in international investment, and uncertainties regarding the issue of how states will treat foreign assets (Helleiner, 1995, p. 331).

The change of perceptions can be large and quick. Some currency crises behave as a self-fulfilling prophecy. They happen to a significant extent because lenders and investors fear they can happen, and speculate against the exchange rate. And, once exchange rates collapse, concomitantly with an asset deflation (in goods, properties and stock markets), the monetary authority tends to defend its currency by raising the interest rates, which can intensify the banking system fragility. Moreover, banking crises disrupt the flow of credit to households and enterprises, reducing investment and consumption, and can also force viable firms into bankruptcy. Banking crises may also harm the functioning of the payments system, and by undermining confidence in domestic financial institutions, they may cause a decline in domestic savings and/or a large-scale capital outflow.

3 - Lessons from recent financial crises

The recent emphasis on asymmetric information explanations for disturbances in financial markets is noteworthy. Traditional currency crises models² imply that countries experiencing an unfavorable economic situation (high inflation rate, debt/GNP ratio or uncontrolled monetary expansion) are more probable to suffer speculative attacks. However, this was not the case of Asian economies on the threshold of the 1998 crisis. If financial traders support their investment decisions on incomplete information, it is conceivable that financial instability could strike both sound and vulnerable economies. In such situations economic models can be deceiving, as random and unpredictable shocks become important.

² See Krugman (1979) for a first generation or canonical model or Obstfeld (1994) for a second generation model.

The economic stability, especially in currency markets, is strongly dependent upon the prevailing exchange rate regime and the total foreign assets reserves. The flexible exchange rate regime is inherently unstable, since the consequences of a shock are hardly foreseen. Supposedly, the exchange rate would vary, in order to automatically adjust current account imbalances, so that the monetary values of exports and imports would always be equated. Consequently, domestic economies would be insulated from external monetary shocks, once the exchange rate flexibility gives the country an extra degree of freedom in choosing its domestic macroeconomic policy mix and its own inflation-unemployment trade-off (Walter, 1993, p. 58). In fact, there is no guarantee that trade volumes would react quickly to changes in terms of trade in order to maintain the long run purchasing power parity (PPP). The duration of the adjustment process is determined by the import and export elasticity's, which may lead to perverse effects like the **j-curve effect**. Furthermore, the income elasticity's of demand for imports and exports themselves constrain the economic growth rate consistent with a balance-of-payments equilibrium (McCombie, 1997; Thirwall, 1997).

In a liberalized environment, it is likely that financial markets respond more rapidly than goods markets to shocks, as a result, this may cause the phenomenon of overshooting of exchange rates. Even assuming that market participants are rational, this cannot indicate that they know the equilibrium exchange rate. In fact, this notion can be very misleading, once long-term fundamentals are of limited importance for market agents or, in addition, they may have a wrong model of economic fundamentals. In the liberalizing scenario of the post-1973 period — which must be understood in terms of a threatened hegemony striving to maintain its monetary and financial supremacy (Eichengreen, 2000, p. 188; Arrighi, 2003, p. 54) — the exchange rate movements have been largely unanticipated by the market (Walter, 1993, p. 61).

On the occasion of a foreign investment, non-residents usually realize their lack of information and thus, by being more risk averse, they are more likely to be susceptible to changes in the host country's economic fundamentals and reduce both investment amount and term. Even in the absence of privileged information, or in cases where the information is available at reasonable costs³, the use of this information is not maximized, or properly deployed. There are

³ Investment bank reports, technical analysis from independent consultants and balance sheets of relevant firms are easily acquired at low costs nowadays.

two hypothesis for this irrational behavior: (a) there are noisy traders⁴ who behave in a psychological manner, taking heed of gossip and underestimating the importance of economic fundamentals; (b) it may not be profitable to collect a great quantity of information if the investment's amount is quite small (Bebczuk, 2000). These issues are causes of financial vulnerabilities and pathological behaviors⁵ such as asset bubbles, contagion effects and herding movements.

Calvo & Mendoza (2000) developed a model to explain the contagion effects, which rests upon the fact that high-quality information is costly. After the international financial liberalization, there was a significant increase in investment options across countries, which reduced the marginal utility of acquiring veracious information. Thus, when confronted with pessimist rumors, it is less costly to allocate the portfolio elsewhere, than to verify the truth about a country's fundamentals. In the face of circumstances of a high degree of uncertainty, Keynes's ideas about conventional expectations, and the metaphor of the beauty contest are still valid. Minor market participants, with little access to financial information or reduced research activities, usually adopt a "follow the leader" strategy pursuing the conduct of a major bank or investor. In other words, the standard "(...) investors invariably base their decisions on the general perception of the market, rather than on a systematic analysis of economic fundamentals" (Griffith-Jones, 1998, p. 176).

The literature on financial crises and its contagion effects is vast. Eichengreen, Rose & Wyplosz (1996) argue that contagion appears to spread more easily to countries which are closely tied by international trade linkages, than to countries in similar macroeconomic conditions. A devaluation induced by a speculative attack increases a country's competitiveness, but makes the currency of its trade partners more vulnerable, due to a loss in reserves and trade deficits — this is called a "beggar-thy-neighbor" devaluation. Drazen (2001) presents a model that includes political aspects into the decision of whether to defend the currency against a speculative attack or not⁶.

Chang & Velasco (1998) emphasize the role of liquidity in the international system to diminish the likelihood of financial crises. They infer that a great proportion of short-term debt over the total debt reduces the willingness of the international financial sector to grant new finance to the debtor. For Corsetti,

⁴ This idea was firstly presented in De Long, Shleifer, Summers and Waldmann (1990).

⁵ The study of **behavioral finance** addresses many of these anomalies. Cf. Thaler (1992), Thaler and Mullainathan (2000) and Kahneman (2000).

⁶ When the main objective of the policymaker is to maintain a fixed exchange rate with regard to its "neighbors", the devaluation in one of these countries may result in speculative pressures.

Pesenti & Roubini (1998) the Asian crisis was the outcome of moral hazard phenomenon that resulted in an over-borrowing process. Foreign lenders would concede loans to households and enterprises up to the limit of sovereign reserves⁷. In this scenario, unprofitable projects and monetary losses are disregarded, and the investment is refinanced. Eventually, a refusal of foreign lenders to continue financing cumulative losses, constrains the monetary authority to intervene and to bail out the foreign debt stock. Therefore, the financial crisis becomes a currency crisis once the government is impelled to take up a monetary expansion, and then a speculative attack would occur by way of canonical models⁸. The authors state that the government must warrant the economy's solvency by proceeding an appropriate fiscal reform.

Mishkin (2000) agrees with previously referred authors and considers that the financial liberalization worldwide provoked an exacerbated credit expansion, which culminated in riskier loans. This excessive risk-taking strategy was motivated by the adverse selection issues since managers of banking institutions are often urged to over-lend, in order to gain market shares and reach their goals. As a further matter, in the Asian crisis, depositors and foreign lenders to the banks in East Asia, believed that there was likely to be government bailouts, or an external lender-of-last-resort institution to protect them, which, in addition to an inadequate regulatory and supervisory system, created serious moral hazard problems.

So, the unrestrained credit expansion made the firm's balance sheets more fragile⁹. As the bank's liability deteriorates due to losses in credit operations, it intensifies distrust in the ability of the monetary authority to absorb such losses. Thereby, the elements of a banking crisis are all set up, together with currency crisis caused by capital outflows. According to Mishkin (2000, p. 18), the asymmetric information analysis of the Asian crisis provides important lessons: (a) there is a strong rationale for an international

⁷ "Because of moral hazard banks borrowed heavily in foreign currency, and their debt position were often short-term and unhedged, as borrowers acted on the presumption that the exchange rates would remain stable, and they would be bailed-out if things went wrong. When indeed things went wrong and a series of domestic and external shocks revealed the low profitability of past investments, the shaky foundations of investment strategies in the region emerged, and currency and financial crises appeared inextricably intertwined" (Corsetti; Pesenti; Roubini, 1998, p. 30).

⁸ See Krugman (1979).

⁹ Foley (2000, p. 9) developed the Hyman Minsky's framework of financial fragility to explain the over-borrowing process. "When interest rate policy stabilizes the growth rate, a positive growth rate shock can set off a dynamical path that brings the economy into the ponzi regime of financial fragility."

lender-of-last-resort; (b) without appropriate conditionality for this lending, the moral hazard created by operation of an international lender-of-last-resort can promote financial instability.

In recent cases of currency crisis¹⁰, the IMF had played a role in providing liquidity¹¹ to the frail countries in order to fulfill their debt service pledges to economic power's banks. Thus, the IMF activities must be analyzed in terms of American interests. But then again, there is a moral hazard problem on this external debt management. A regulation in the source country, or on an international basis, would be necessary to avoid over-borrowing because private rationality induces investors and creditors to persist assuming excessive risks since they are confident in external financial assistance.

4 - Financial stability: undertaking tasks towards a new financial system

In the 1990s, the whirlwind in international markets led to debates about reforming financial systems with the purpose of improving general stability and preventing further crises. The IMF has played a central role in these discussions, putting forward proposals for strengthening the architecture of the international financial system. Several other agencies such as IOSCO, World Bank, FSF and the Basel Committee on Banking Supervision (BCBS) took part in the development of this new architecture. See tables 1 and 2 in appendix for the recent works of these agencies pertaining to the soundness of financial systems.

4.1 - IMF initiatives

The IMF has been issuing several documents and guidelines with regard to financial sector reforms. One of these guidelines, titled "toward a framework for financial stability", listed the main principles to strengthen financial sectors around the world and it is intended to furnish guidance for the direction in

¹⁰ Europe in 1992, Mexico in 1994, East Asia in 1997, Russia in 1998 and Brazil in 1999.

¹¹ The restructuring of debt obligations is difficult to settle when the securitized exposures are owned by a great number of investors.

which supervisory structures and financial system reforms should progress. Among these features, it includes transparency of the financial system, competent management, effective risk control system, adequate capital requirements, lender-of-last-resort facilities, prudential regulation, a supervisory authority with sufficient autonomy and capacity, and supervision of cross-border banking. The Fund's work on financial restructuring has focused on the banking system, due to its primary role as financial intermediary in many member countries and to the limits of staff expertise (IMF, 1998). Evidently, the IMF acknowledges the asymmetric information problems in financial markets, which were learned from the latest crises, and it has been chasing to overcome or diminish them through its surveillance capabilities, improving the international regulatory framework, and spreading relevant financial information.

The IMF is striving to improve transparency and the quality of information, since the publication in its website of the special data dissemination standard (SDDS) and the dissemination standard bulletin board (DSBB) in 1996. It is also concerned with the international compatibility of reporting standards. The logic beneath these reports is that "(...) transparency and timely release of economic information provide the bare bones of crisis prevention" (Griffith-Jones, 1998, p. 178). The use of financial soundness indicator (FSI) is an attempt to enhance the data dissemination and the monitoring of financial vulnerabilities. The IMF intends to compile and disseminate the FSI.

The Fund has strengthened its surveillance role (article IV) by examining attentively the financial sector. One of the most important programs, the financial sector assessment program (FSAP), started in 1999 and it has a wide scope. The FSAP is a joint product of the IMF and the World Bank and its principal objectives are: (a) identifying strengths, vulnerabilities and risks; (b) ascertaining development and technical assistance needs; (c) assessing observance and implementation of relevant international financial sector standards, codes and guidelines; (d) making financial systems more resilient to shocks and; (e) helping the design of appropriate policy responses. This program consists in the analysis of financial soundness indicators (macroeconomic factors and sectoral indicators), assessment of key supervisory standards (banking, insurance and security markets) and the assessment of the robustness of financial sector infrastructure (payment system design, systemic liquidity, accounting/disclosure, corporate governance, insolvency regime and safety nets). This program comprises 14 regulatory agencies and standard setters, as the BCBS, IOSCO, International Association of Insurance Supervisors (IAIS) and Financial Action Task Force on Money Laundering (FATF), and so far have undergone about 100 economies.

The FSAP represents a major effort to diagnose the different financial systems in order to provide a solid basis to propose reforms and assure financial stability of markets worldwide. The program's cost has become excessively high (Financial Stability Forum, 2003) but its benefits are relatively moderate, or faintly discernible, since the financial sector assessment reports are confidential. Certainly many contributions could have been obtained if these documents were available for academic affairs. Even so, based on this research, the IMF identified problems in developing countries: weak financial institutions, inadequate bank regulations, and supervision and preferential relationships between government, banks and corporations. We must be aware that financial structures differ very much around the world. Looking at financial systems across different income groups, Demirguc-Kunt & Levine (1999) conclude that financial sector development tends to be greater at higher income levels.

Another important report, the global financial stability report (GFSR), is planned for publishing semiannually. "It assesses conditions and risks in global financial markets, including emerging market financing, from a financial market stability perspective" (Financial Stability Forum, 2003, p. 12). This report may compile and present the FSAP major findings, although the IMF did not manifest it. The document published in March 2003 reported that corporate balance sheets strengthened, and that financial institutions were showing signs of being less hesitant to take on risks. Thus, the easing of global financial market conditions led to a reopening of capital accounts in many emerging markets. Notwithstanding, it also stressed that an unexpected rise in interest rates could result in high market volatility. The GFSR also emphasized that larger local security markets could eventually provide an alternative source of financing, and act as a buffer against changing global financial conditions.

The IMF has also been assisting other agencies like the FATF and the FSF in the performance of their duties. The assessments conducted by the IMF are essential methods to assure that the recommendations of the FATF, as well as principles of other organizations like IOSCO, IAIS and Committee on Payment and Settlement Systems (CPSS) are being fulfilled.

Though priority is given to crises prevention, the Fund is also remodeling its measures of crises management. The efforts on crisis resolution are based on a process of restructuring sovereign debt within the existing legal framework, which includes the amendment of collective action clauses (CACs) in international sovereign bonds. Besides this, the IMF is encouraging initiatives aimed at formulating a voluntary code of conduct for sovereign debtors and their creditors (Financial Stability Forum, 2003). With reference to emerging

markets and low-income countries, the IMF claims to base its new outlook on the Monterrey consensus (also known as the millennium development goals) and the poverty reduction strategy paper (PRSP). Despite critics regarding moral hazard issues (IMF, 2003b), the IMF admit its role as alender-of-last-resort in some adverse situations, but it suggests that “(...) the overall objective of Fund policy advice and financial assistance should be to facilitate the transition, to the point where low-income members can rely predominantly on private sources of financing” (IMF, 2003a, p. 2). Indeed, poor countries have less mechanism to respond to the effects of external shocks, so the IMF has an important role in the provision of financial assistance. But the ‘rescue’ is conditioned on macroeconomic reform efforts, which can aggravate the situation and cause severe social problems.

The Fund’s measures demonstrate a complacency to the interests of economic powers, namely the United States¹². Gowan (1999), for example, goes further; for him, the IMF was an instrument to extend the dollar-wall street regime¹³ around the world.

4.2 - Capital controls

The IMF has traditionally stressed the importance of capital account liberalization, which major benefits would include the increase in the availability of finance for investment and trade, the enhancements in domestic financial system efficiency, and the diversification of risky assets. However, it admits that if this liberalization is not done in a prudential and properly sequenced way (IMF, 1998), the emergence of free capital movements may give rise to potential vulnerability. Large-scale inflows, in many cases, hindered the conduction of the domestic monetary policy and promoted pressure on exchange rates. Thus, controls on capital inflows are emerging as a national

¹² Carvalho (2003) presents an analysis on the role of IMF on emerging markets, in special the Brazilian case.

¹³ Gowan’s ideas of an American conspiracy to destabilize East Asia’s economies seems too unrealistic, because it would require too much coordination. For him, “(...) the US treasury was to view the [Asian] crisis as a historic opportunity which, if seized, could transform the future of American capitalism, anchoring its dominance into the twenty-first century” (Gowan, 1999, p. 105). Moreover, in the Asian crisis “(...) the US government refused to take any positive action to stabilize financial systems and currencies and kept the IMF on a leash” (Gowan, 1999, p. 106).

level alternative to the erratic behavior of international capital¹⁴. The aim of capital regulations are: (a) to change the structure of capital inflows, increasing the share of foreign direct investment and long-term loans; (b) to raise the autonomy of domestic monetary policies and; (c) to restrain large over valuation of the exchange rate, caused by sudden capital inflows. Nevertheless, capital controls are not a straightforward solution, it may require an adequate system of information, a regular maintenance and have inherent costs associated with it. According to the Financial Stability Forum (2000) these costs, despite being difficult to quantify, must be seriously taken into account once they include: (a) the distortion of an efficient allocation of resources; (b) a postponement in the implementation of necessary policy adjustments and; (c) opportunities for corruption.

Chile is a case where the benefits of capital controls overcame its costs. The Chilean authorities opted to reduce the incentives for capital inflows through market-based regulations. They imposed an unremunerated reserve requirement, which raised the cost of short-term external financing. Additionally, a minimum holding period was introduced for direct and portfolio investment, yet the regulations have been made more flexible over time. For instance, restrictions on foreign exchange transactions and capital outflows, including repatriation of profits, have been progressively eliminated. Even though, the pension fund and insurance company holdings of foreign assets are still limited (Griffith-Jones, 1998; Financial Stability Forum, 2000).

Griffith-Jones (1998) proposes the settlement of controls on an international level. A risk-weighted cash requirement for mutual funds in source countries, varying with macroeconomic evolution in developing countries, would bring about an attenuation of financial flows¹⁵. However, this kind of initiatives has not been discussed in multilateral organizations.

There is general agreement that a large surge of short-term capital flow is endowed with tremendous volatility, which poses the risk of very sharp reversals. Someone could point out that the solution is merely to impose controls over capital inflows. However, regulation of short-term capital flows are difficult to be perfectly implemented and an international effort might be desirable since "(...) the current system provides strong regulatory incentives towards more short-term loans, and less for long-term loans. Portfolio

¹⁴ See Oreiro, De Paula & Silva (2003) for a Brazilian proposal for capital controls and pegged exchange rate regimes.

¹⁵ Another idea, that is apparently overcome, is to create a very small international tax on all foreign exchange transactions (this was known as the Tobin tax).

flows are at present totally unregulated by source countries" (Griffith-Jones, 1998, p. 168).

4.3 - Capital accord

The debt crisis of 1982 engendered by Mexico's default, and spread to other Latin American countries, shifted the focus of banking regulators to crisis prevention measures. The aim behind these measures was to protect deposit insurance funds from the results of excessive risk-taking by imprudent bank managers. However, due to capital mobility, cross-border regulations should be internationally standardized. In a competitive banking industry, any cost disadvantage can narrow margins, and put a whole national financial system in a harmful position. The discussion about over regulation, unfavorable competition, and the soundness of financial system, embodies a myriad of issues and interests that central banks and bank supervisors must manage.

Negotiations gathered in the BCBS achieved in 1988 a capital definition and measurements of capital adequacy. The document titled **International Convergence of Capital Measurements and Capital Standards** was designed to (a) provide a common definition of capital, which comprised shareholder's equity, retained earnings, minority interests in subsidiaries, and perpetual debt; (b) adopt a risk-weighted method to evaluate a bank's capital adequacy; (c) include off-balance sheet commitments in capital adequacy determination (Kapstein, 1994). The accord is based on the notion that a large capital base is meant to serve as a buffer to absorb losses and, therefore, provides the institution with credibility, and its customers with confidence in the institution. The Basel accord represented a significant step in policy convergence and the creation of an international banking regime, with formal principles, norms, rules and decision-making procedures. Thus, the accord would contribute to increase the banking system's soundness internationally.

The financial crises in the 1990s stood out flaws in the 1988 accord. Notably, among the imperfections that we may point out, the deviating behavior and moral hazard problems maximized by potential risk-sensitive issues, would bear riskier activities (high-yielding loans would compensate the costs of holding capital). Besides, short-term bank lending to the emerging markets has been encouraged by a relatively low twenty per cent risk weight, while bank credit to non-OECD banks with a residual maturity of over one year has been discouraged by a hundred per cent risk weight. This has stimulated cross-border inter-bank lending (Weder; Wedow 2002, p. 6).

These shortcomings compelled the creation of prudent regulations and surveillance instruments more adequate to the prevailing rationality of globalized financial markets. "The new framework is intended to align capital adequacy assessment more closely with the key elements of banking risks, and to provide incentives for banks to enhance their risk measurement and management capabilities" (Bank for International Settlements, 2001, p. 1). The accord is structured in three pillars¹⁶ which would, together, contribute to a higher level of safety and soundness in the financial system.

After years of negotiations, in the mid 2004 the new regulations were eventually compiled in the new Basel accord, which is to be implemented in a common member countries agreement by the end of 2006.

4.4 - Other principles and standards

Apart from the standard principles of banking activities and capital definitions compiled in the Basel accord, other elements of the international financial system, has been the focus of research on standardization principles. A good regulatory and supervisory standard and a single definition of financial features, such as securities and accounting, is deemed to ease efficient comparisons of information¹⁷ and would yield to better market discipline.

The Joint Forum

The banking, insurance, and securities sectors, constitute the key parts in a financial system. The joint forum comprises international organizations related to each one of these sectors:

- Basel Committee on Banking Supervision (BCBS);
- International Association of Insurance Supervisors (IAIS);
- International Organization of Securities Commissions (IOSCO).

¹⁶ I) Minimum capital requirements; II) a supervisory review process; and III) effective use of market discipline.

¹⁷ Bebczuk with regard to the banking sector argues that "(...) as a consequence of informational problems, the availability of internal funds affects the macroeconomic dynamics by broadening the gap between the cost of external finance and the amount of firm's funds" (Bebczuk, 2000, p. 154) thus, "(...) when informational barriers are overcome, the customer relations create a symbiosis between the bank and the debtor" (Bebczuk, 2000, p. 165).

Each organization issued its own set of core principles, primarily designed to set up a common framework for regulation and supervision, which would favor the development of sectorial markets (banking, insurance and securities) around the world.

Indeed, supervising these financial sectors is not an easy task. For example, the use of derivatives and other off-balance sheet transactions make banking supervision more difficult, justifying debates between the IOSCO and the BCBS through the Joint Forum. In addition, the lines between the sectors have become increasingly blurred with the growth of financial conglomerates. There are banks engaging in securities activities, securities firms selling and exchanging trading financial instruments designed to hedge risk, and insurance companies offering savings vehicles.

Some of the similarities and differences among the core principles reflect intrinsic characteristics of the banking, insurance, and securities sectors. The Joint Forum decided to gather and compare these principles and released a report. It "(...) hopes that this analysis will help those assessing jurisdictions against the core principles gain a familiarity with, and understanding for, the core principles of all sectors and thus become more effective in their work" (Bank for International Settlements, 2001b, p. 1).

Financial Stability Forum (FSF)

The FSF is another important forum for debates on the stability of the international financial system. It brings together representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings and committees of central bank experts. The Forum has been complying with its mandate, that is, to: (a) assess vulnerabilities affecting the international financial system; (b) identify and oversee action needed to address these; and (c) improve the coordination and information exchange among the various authorities responsible for financial stability. The FSF does not have an authoritarian nature, but it seeks to conduct the multilateral agenda for international financial system reforms.

Financial Action Task Force on Money Laundering (FATF)

The FATF was formed in 1990, with the directive of issuing recommendations to combat the misuse of financial systems by persons

laundering drug money. In 2003, the FATF revised its forty recommendations. They now apply not only to money laundering, but also to terrorist financing, when combined with the eight special recommendations on terrorist financing. These recommendations set minimum standards of action for countries to implement the details in accordance with their particular circumstances and constitutional frameworks (Financial Action Task Force, 2003).

This document contains, for example:

- a list of crimes that must underpin the money laundering offense;
- anti-money laundering measures for designated non-financial businesses and professions (casinos, real estate agents, dealers of precious metals/stones, accountants, lawyers);
- anti-money laundering requirements to cover terrorist financing;
- key institutional measures regarding international cooperation; and
- the improvement of transparency requirements through adequate and timely information on the beneficial ownership of legal persons, such as companies, or arrangements, such as trusts.

There has been a collaborative effort between the FATF, the United Nations and other international organizations, to encourage all countries to implement the recommendations.

Committee on Payment and Settlement Systems (CPSS)

The Committee's objective is to analyze the international payment system, identifying possible failures, and proposing a standard infrastructure. For example, in the report on the role of central bank money in payment systems, the CPSS looked at the issue of competition and cooperation between central banks and commercial banks, and dealt with issues such as the possible benefits and risks of the concentration of payments through a few large banks.

International Accounting Standards Board (IASB)

The standardization of accounting practices is a relevant dimension of market discipline. The new Basel accord lists several disclosure recommendations and accounting requirements under pillar three. Hence, the IASB is working with the BCBS to review its disclosure standard (IAS 30) for banks, and to promote consistency between frameworks.

In the light of crisis prevention, the great majority of the referred programs and reports present a common aspect. They emphasize the market coordination

on capital allocation in accordance with the prevalent regulatory governance¹⁸. Multilateral and national organizations seek to attain the role of providing market participants with information and transparency. The IMF's financial sector assessment program (FSAP), and financial soundness indicators (FSI), and the pillar three of the new capital accord are good examples of the market discipline reinforcements. Additionally, The disclosure of bank's internal information, such as risk exposure, capital adequacy and methods of calculating capital requirements, would also provide the market with a greater transparency. The Financial Stability Forum (2000) recommends a broad policy of risk management strategy that involves a system for monitoring and assessing the risks and liquidity in the economy as a whole, including at a sectional level (banking sector, non-bank financial institutions and non-financial institutions). The inner reasoning behind these guidelines is that information enhances competition, so that countries, banks and other market participants have strong incentives to present sound indicators, likewise market capitalization, liquidity, inflation rates and debt/GNP ratio.

However, the economic logic with reference to the disclosure of financial information is not an end in itself, consequently we may not neglect international relation aspects, namely the geopolitical interests of economic powers (notably, members of the Group of Seven) in the liberalization and deregulation in emerging markets as a means to extend their zone of influence¹⁹.

5 - Is it enough? Trends and impacts

The latest activities of agencies related to functioning of the international financial system display a general concern with the unstable environment where different economies (from emerging markets to central economies) are

¹⁸ "Good regulatory governance in the financial system is increasingly being recognized as key to the achievement and preservation of financial stability. Four components have been identified as being key to good regulatory governance. They include (i) independence of the agency from political and industry interference; (ii) accountability; (iii) transparency; and (iv) integrity" (Das; Quintyn, 2002, p. 48). See also, OECD (1999), for details on the rights and treatment of shareholders, as well as the principles of disclosure and transparency.

¹⁹ As Arrighi (2003, p. 55) put it, "(...) the United States benefited both economically and politically as American business and governmental agencies were best positioned to mobilize in the global competitive and power struggles for the cheap commodities and credit which southern **winners** eagerly supplied, as well as for the assets the southern **losers** had to alienate willy-nilly at bargain prices".

immersed in. Based on the diagnosis of recent financial/currency crises, sundry proposals have arisen with the intention of making the financial system more transparent, and its regulations more uniform (through the development of principles and codes of conduct) and so, reducing information problems. Notwithstanding, many questions still unanswered. What will be the major impacts of these changes? Does the system become more stable with them? Are the diagnoses correct? Is there room for thorough reforms in the international monetary system structure?

Certainly the Basel accord of 1988 represents an important effort in setting common rules for the banking activities. And by creating a new standard for assessment, it made possible a market discipline. The new Basel accord framework relies on markets and supervisors to discipline banks, and it also enhances the importance of rating agencies in the assignment of capital requirement weights. In the case of emerging economies, crisis events have proven to be one of the most important determinants of sovereign ratings, and so, even if the new Basel accord have minor effects on international loan flows, it "(...) may lead to an increase in the volatility of international lending to emerging markets" (Weder; Wedow, 2002, p. 24). Additionally, according to Ward (2002, p. 2), "(...) the new accord is not, as its designers claim, suitable for wide application (...) developing country policymakers have little choice but to implement it in part, or in whole. Hence, there are problems of governance in international regulation". The BCBS is not a supranational organization. The discussions were led by the prevailing economic powers²⁰, in attendance of their own interests.

Despite the efforts of the BCBS and the Joint Forum, there is no solid standard for assessing the strength of the banking and non-banking financial sectors. In fact, the available information can be misleading as the health of financial institutions deteriorates in a crisis (Griffith-Jones, 1998), since "(...) a major shock to expectation may dramatically change the very definition of solvency" (Walter, 1993, p. 53). Therefore, the solvency problem in one market could easily raise doubts about the solvency of others. This sort of contagion phenomena is difficult to restrain, since there is no clear connection to economic fundamentals.

As previously mentioned, the asymmetric information problems in financial markets were diagnosed as a central source of instability and they would be

²⁰ With regard to the 1988 accord, Kapstein (1994, p. 128) argues that "(...) without the exercise of American power, a capital adequacy accord might not have been reached (...) the gap between talk and action was bridged only when the United States provided the planks".

damped through effective disclosure activities. The market forces would then provide incentives for the agents to pursue sound indicators, and not behave in an opportunistic manner. Nevertheless, the transparency and data dissemination programs enlarged the stock of available data so much that it thwarts the acquirement of relevant financial information and demands huge information processing capabilities. Therefore, even with information and transparency improvements, it is doubtful that this will lead to a better investment decision and extinguish the threat of market overreaction. In a crisis situation, the market (sometimes this word almost seems to have a mystical meaning) may not take reasonable and adequate actions to soothe economic panics. In other words, it is probable that “(...) there may not be sufficient incentives for the market to undertake a lender of last resort role itself” (Walter, 1993, p. 53). When a large currency crisis starts, the importance of safeguard institutions is stressed²¹, and so do the harmful features of short-term capital flows.

After the collapse of the Bretton Woods system, the incipient²² liberalizing ideals spread all around. These ideals were condensed in the Washington Consensus, which was entirely observed as a checklist by emerging economies, with the assurance that it would attract international capital flows and promote an economic development. The Brazilian crisis in 1999, and Argentinean crisis in 2002 shattered the confidence in some of these liberalization principles. Hence, in spite of various criticisms, the Bretton Woods system remains a model for international financial stability. Griffith-Jones (1998, p. 184) argues that “(...) there is a growing consensus — further strengthened after the Asian crisis — that, though no panacea, discouraging short-term flows by recipient countries is one of several useful policy instruments for better management of capital flows and reducing the risk of currency crises”. Some proposals²³ attempt to recover some principles of this system, just as a restriction to capital movements, the regime of fixed exchange rates, and the scarce currency clause²⁴.

²¹ “(...) states can provide the public good of stability that the private market is unable to provide itself” Kindleberger (1978, p. 4), *Manias, Panics and Crashes: a history of financial crises* *apud* Helleiner (1995, p. 331).

²² The overall globalization process was never interrupted during the Bretton Woods lifetime: there were technological developments (specially in telecommunications); the private sector restored its confidence in international financial transactions; multinational corporations grew fast; and industries around the world began a pressure for deregulation (Helleiner, 1995).

²³ See, for example, Oreiro, De Paula and Silva (2003).

²⁴ In fact, these 3 principles had never worked harmoniously in Bretton Woods. The IMF resources were never adequate to the necessities of balance of payments disequilibriums

The recent reforms undertaken in the international financial system did not truly create a new architecture. Reminiscent institutions from the Bretton Woods system, like the IMF and the World Bank, are still operational, but they are not performing their original responsibilities entirely. As Stiglitz asserts, “(...) building a robust financial system is a long and difficult process. In the meantime, we need to be realistic and recognize that developing countries have less capacity for financial regulation and greater vulnerability to shocks”²⁵. At present, the monetary order, based on a flexible exchange rate regime and multi-currency system, can be considered somehow anarchical.

5.1 - Beyond economics

Policy coordination appears to be crucial to a systemic stability. A fixed or pegged exchange rate regime requires a coordination of economic policies that pledges to maintain a cross-rate level. On the other hand, for the success of a flexible exchange rate regime, the stability of market expectations is fundamental. Policy coordination — between states too — must prevent a major misalignment of currencies. However, this is an arduous task in an environment of monetary decentralization, high level of financial integration, and rapid mutations. Therefore, one of the main functions of hegemony is to foster coordination between policies of different countries. As Charles Kindleberger put it, “(...) for the world economy to be stabilized, there has to be a stabilizer, one stabilizer”.²⁶

When the hegemony’s currency becomes the key currency in the international monetary system, as had happened to the dollar, the hegemony is able to play a stabilizing role in the system. The hegemonic intervention is generally associated with the establishment of a regulatory framework for global financial transactions, which often means the encouragement of principles of free trade and free capital movements. Another important role that may be performed by hegemony involves the support of policy coordination between states or even an active management of the international monetary/

and the scarce currency clause, design to punish countries that threaten the systemic stability, was never put into practice (Eichengreen, 2000).

²⁵ Stiglitz, J. “The role of international financial institutions in the current global economy” address to the Chicago council on foreign relations, 27 February 1998 *apud* Griffith-Jones (1998, p. 182).

²⁶ Kindleberger *apud* Walter (1996, p. 128).

/financial system. That is not to say that the presence of a hegemonic economy is a sufficient condition to solve the issue of international financial instability. “Economists are more often aware of the potential for financial markets to create their own instability, leading to a need for them to be managed and regulated” (Walter 1993, p. 79). So, perhaps only a discretionary intervention by the government, the monetary authority or from a supranational institution can mitigate capitalist instability, creating ceilings and floors constraining the dynamic behavior of the system (Bellofiori; Ferri, 2001).

So, the theory of hegemonic stability provides a good standpoint for the study of international relations, once it brings out indications of necessary conditions for the stability of the international economic system. This theory is sustained on a neorealistic approach²⁷ which more recently got support after the terroristic attacks that justified an American imposition of more rigid trade rules to prevent bio-terrorism, and impelled the establishment of additional recommendations from the FATF, designed to enhance the international framework for combating money laundering and terrorist financing.

Presently, the multi-currency system, constituted by the dollar, euro and yen, reveals the multipolarity of interests in the monetary system. Even if exchange rate stability is more likely to occur within a currency bloc, such as the European exchange rate mechanism (ERM), this type of arrangement is essentially volatile, because of the potential for destabilizing portfolio shifts between key currencies. Some may state that key countries' central banks should coordinate their monetary policies — similarly to the Plaza accord in 1985 — pursuing a world monetary target in order to stabilize PPP prices of internationally traded goods. But the international capital mobility causes the money supply to become endogenous, which hinders monetary coordination (Walter, 1993).

The conundrum of international adjustment has never been solved throughout the years and different monetary systems. Since there was never a world currency, historically the international liquidity was provided by the economic powers through imports, loans, bonds and investments. And this is one of the possible causes for the disequilibria among surplus countries and countries showing deficits in their balance of payment, which may be harmful, specially to small economies that need to export merchandise in order to obtain reserves to commit to its debts and to import essential goods, like oil.

²⁷ “Neorealists hold that states have different policy preferences that depend upon their relative positions in the world economy (...) The hegemony structures the system for its own benefit, although significant benefits for other may result. The hegemony uses its power to enforce other states' compliance with the prevailing rules.” (Walter, 1996, p. 129).

Who should adjust? There has always been a conflict between national autonomy and the international stability. In Bretton Woods, Keynes proposed a collective management of surpluses and deficits by a central bank, and an international clearing union, which would issue the international currency, the *bancor*. In his plan, both surplus and deficit countries would be sanctioned for threats to the stability of the system. This kind of arrangement seems almost utopian, because it involves sovereignty, geopolitical issues, and a huge transfer of resources to a "world central bank".

The current situation of globalization has led some authors to argue that sovereignty is not a relevant issue anymore²⁸. This is very debatable, since there was no transformation of the international order (Boron, 2002), and it is unlikely that a global government would soon emerge. Furthermore, there is no evident global governance, even in highly globalized activities, such as finance. The financial systems remain linked to national supervision and regulations, and the concept of "balance of power" among states, is important to understand the current financial architecture and to realize the potential of deeper transformations in the system. For instance, in 1944 the American hegemony made possible the establishment of the Bretton Wood system²⁹. Even though the economic powers have had a major role in the negotiations of financial regulations, as the Basel accord, at present, there is no evident hegemonic power capable and willing to impose a new international framework. Nevertheless, we are not confident that a high degree of centralization would surely resolve all difficulties, much will depend upon the policies that the dominant states in the system would follow.

The present global balance of power is somewhat fragile. The United States maintains its military power, but the economy is not as exuberant as it was during the 1990s. It is facing an enormous double deficit — a fiscal deficit of six per cent of the GDP, and a current account deficit of five per cent of the GDP, according to the IMF's **World Economic Outlook** (IMF, 2003c) — the investment and savings rate are falling; facts that evinces the difficult economic situation that the US must defy. China, on the other hand, is arising as an incubating economic power. The country has the world's largest population, it is increasing its military capacity, and has a very dynamic economy (its

²⁸ For Hardt & Negri (2000), the notion of nation-state is not relevant anymore. For Strange (1996), the state system has been eroded and the world economy is in operation on its own.

²⁹ "US dominance or **hegemony** was the linchpin of the successful world capitalist economy after 1945. In the late 1940s, not only did the United States possess unrivalled power and prestige, it also had purpose" (Walter, 1996, p. 127).

gross domestic product, in dollars, may surpass that of the US in 2041). In 2003, the country has also accumulated the world's second largest foreign currency reserve (Wolf, 2003a). The Asian countries in general, are providing the US with goods and services in return for overpriced bonds, and as a consequence, they are the major source of financing for America's current account deficit.

A monetary coordination among the economic powers seems extremely wanted and it would involve exchange rate realignments among the key currencies of the international monetary system³⁰. Indeed, the announcement of the Group of Seven in Dubai, stated that more flexibility in exchange rates is desirable in major countries or economic areas to promote smooth and widespread adjustment in the financial system, based on market mechanisms. But then, other questions emerge. How to proceed with these adjustments? What is the exchange rate equilibrium level? How to restore confidence in the American economy? Hitherto, the dollar has already been devaluated. But, "(...) any substantial further appreciation would threaten Japan's fragile recovery. A big rise in the euro would also be dangerous for the Eurozone. Moreover, a collapsing dollar would undermine foreign willingness to buy US bonds" (Wolf, 2003b). Sudden movements of the exchange rate can also be disastrous for China, which does not have a solid financial system yet. If a confidence crisis starts, foreign investors may cut their holdings of US government debt, threatening the American recovery³¹. In the meanwhile, Europe is struggling to strengthen the euro. However, the vital mechanism of the stability and growth pact — designed to enforce fiscal discipline among member states — is not properly working³².

The lack of room for international coordination of policies in a multipolar environment could induce debates on controls upon international capital flows,

³⁰ There are different points of view for a monetary coordination process. Strange (1996) developed the theory of hegemonic mismanagement; Gowan (1999) stressed the conflictual relations in the monetary system, given that the US would supposedly prefer disorder, rather than a stable monetary system, and Arrighi (2003) studied the crisis of hegemony and developed the idea of an ultra imperial management.

³¹ In fact, at the beginning of 2003 a joint action between the US and Japan seemed to be underway. The Bank of Japan carried out an unorthodox monetary policy, in other words, it was "(...) creating money and buying US treasury bonds, which was helping to drive down US interest rates and underwrite US economic growth — and, by extension, global growth" (Duncan, 2004).

³² According to the Financial Times (2003): Germany and France smashed apart the political deal underpinning Europe's single currency by pursuing their own strategies to reduce budget deficits.

as a condition for stability. However, such initiative would go the other way around the prevailing market-based approach and deregulation policies.

6 - Concluding remarks

Our intention in this paper was to argue whether the changes and proposals undertaken by the international financial agencies would radically transform the system and free the markets around the world from the danger of instability. For this reason, we first addressed the problems caused by financial crises and identified the diagnoses and lessons learned from them. They resulted in a set of prescriptions to prevent and resolve further crises. We then presented the main outlines of the international financial system reform and described the role of different agencies in this process.

The presented programs and reports endeavor to create a more solid regulation framework, and to strengthen the financial institutions, by making them more resilient to shocks. Actually, the efforts on improving financial transparency and data dissemination programs are valuable for diminishing asymmetrical information problems. Hence, we cannot affirm that the reforms are trailing a wrong course, or that they are completely ineffective in bringing financial stability. We are merely raising objections to these programs as the basis for a “new” international financial architecture designed to be more stable.

A simpler analysis, based solely on financial reform propositions and principles, would convey an unsatisfactory outcome. The incorporation of geopolitical affairs, and the examination of broader monetary system transformation, seems to lead to wiser results. Although authors like Gowan (1999) affirm the opposite, we argued that a hegemonic power may provide a satisfactory environment for the establishment of ground rules, which facilitate the operation of a particular kind of monetary adjustment mechanism. At present, with the lack of a true hegemony, it is not likely that an organic alteration in the monetary system can occur.

Thus far, we are not asserting that a high degree of centralization (e.g. the creation of a world central bank) is necessary, or even desirable. First, states and economic powers would not cede their national sovereignty to supranational organizations, despite the European Central Bank experience. Second, there are several complex operational issues with regard to politics. Will the international currency be dealt by commercial banks? How would a world central bank decide whether to provide crisis liquidity? The moral hazard problems related to this function would persist.

The current international institutions may not cater to the needs of a fast evolving financial system. Even though the IMF financing support was important in the context of a crisis resolution, in general, the Fund has played a limited role as an ultimate liquidity provider. In a multipolar situation, it seems even unlikely that the market forces render adjustments to the economic system.

Appendix

Table 1

Recent work relevant to sound financial systems — completed

NAME	AGENCY
Consolidated KYC (“know-your-customer”) Risk Management	BCBS
Cross-border Implementation of the New Basel Capital Accord/E-Banking	BCBS
Markets for Bank Subordinated Debt and Equity in G-10 Countries	BCBS
Principles for the Management and Supervision of Interest Rate Risk	BCBS
Third Quantitative Impact Study for the New Basel Capital Accord	BCBS
Rating Agencies	CGFS
Role of Central Bank Money in Payment Systems	CPSS
Market Integrity for Combating Money Laundering	FATF/Joint Forum (BCBS,IAIS,IOSCO)
Financial Sector Assessment Program (FSAP)	FMI
Foreign Exchange Reserve Management Guidelines	IMF/World Bank
Insider Trading	IOSCO
Transparency of Short Selling	IOSCO
Combating Money Laundering and the Financing of Terrorism	Joint Forum (BCBS,IAIS,IOSCO)
Operational Risk Transfer	Joint Forum (BCBS,IAIS,IOSCO)
Trends in Risk Integration and Aggregation	Joint Forum (BCBS,IAIS,IOSCO)

Table 2

Recent work relevant to sound financial systems — ongoing (up to Dec/2003)

NAME	AGENCY
Revision of the Basel Capital Accord	BCBS
Oversight of Payment and Settlement Systems	CPSS
Implementation of the Plan of Action to Combat Terrorist Financing	FATF
Legal and Institutional Underpinnings of Global Financial Markets	G10
Insurance Principles, Standards and Guidelines	IAIS
Coordinated Portfolio Investment Survey (CPIS)	IMF
Crisis Resolution	IMF
External Vulnerability Assessments	IMF
Financial Soundness Indicators	IMF
Global Financial Stability Report (GFSR)	IMF
Offshore Financial Centre Assessments	IMF
Transparency of IMF Policies and Assessments	IMF
Bank Insolvency Initiative	IMF / World Bank
External Assessments of Implementation through Reports on the Observance of Standards and Codes (ROSCs)	IMF / World Bank
International Financial Reporting Standards	International Accounting Standards Board (IASB)
Auditing Standards	International Federation of Accountants (IFAC)
Enhancing Information Exchange among Securities Regulators	IOSCO
Rating Agencies - Regulatory perspective	IOSCO
E-Finance and Debt Management	OECD
Forum for Asian Insolvency Reform	OECD
Principles of Corporate Governance	OECD / World Bank
Principles and Guidelines for Effective Insolvency and Creditor Rights Systems	World Bank

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