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The International Financial Architecture and Global Institution Building.

A Latin American View [1]

José Maria Fanelli, CEDES-Argentina

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I. Introduction

The second globalization regime has created opportunities for exploiting the benefits of productive specialization and the mutual advantages of trade in goods, services, and financial instruments on an unprecedented scale. A considerable number of countries, especially in Asia, have managed to take advantage of such opportunities. However, the regime also has a dark side. There have been periods of substantial volatility of the exchange rates between major reserve currencies, cycles of abundance and scarcity of international liquidity, and sudden reversals in the direction of capital flows associated with crises and flight-to-quality episodes.

A source of concern is that, despite higher exchange-rate flexibility, deeper capital markets, and freer cross-border financial flows, the system's built-in adjustment mechanisms have not always worked appropriately. This is true of both the mechanisms operating at the national and the global levels: the market reactions and policy responses observed under the existing international financial architecture (IFA) and domestic financial architectures (DFA) have frequently been unable to induce timely and smooth corrections of current account and/or capital account disequilibria and, as a consequence, the economies affected have undergone periods of "disruptive adjustments". Two additional disappointing features are first, that the accumulation of tensions in many instances resulted in growth and financial collapses or "crises" and second, that these crises proved to be "contagious".

If we based our judgment on observed overall economic outcomes, we would see that the LA region has been living mostly on the dark side of the global system. In addition to experiencing several crises, the region's "normal" aggregate income volatility has been substantially higher than that in developed countries over the last three decades. Furthermore, consumption has tended to be more volatile than income while investment volatility has been larger than international standards. Indeed, the region's growth was higher and volatility was lower under the Bretton Woods regime. This is particularly true with regard to the three largest economies. These economies have shown a mediocre growth performance and vulnerability to external financial shocks (ECLAC, 2008). The most notable exception to this regional picture is Chile and to a certain extent the Dominican Republic. But even in these cases, financial crises have not been absent. In Chile, the growth path consolidated only after the occurrence of a deep financial crisis, which was one of the first under the second globalization and anticipated several of the features that would characterize the crises in the emerging world. In the Dominican Republic, the growth process was interrupted by deep financial disequilibria at the beginning of the current decade. Neither of the two exhibits a growth performance that is comparable to the Asian miracles.

The contrasting performance of LA and Asia is just one example of the striking disparities observed in the growth and macro volatility paths of different economies around the world. Over the last three decades economic miracles persistently coexisted with recurrent financial and growth collapses. Real-side and political phenomena–such as uneven changes in productivity throughout the world, terms-of-trade shocks, the demise of the Socialist Bloc, and the 2001 terrorist attack–can go a long way in explaining the different performances and international instability. Yet, there is abundant evidence that the failures in the governance of global financial transactions have also played a significant role. After the occurrence of a shock, the degree of persistence of the ensuing disequilibria and the stability of the adjustment process depend crucially on the system's ability to "filter" or dampen the effects of the shock. If the system tends to generate disruptive adjustments, any sizable shock could destabilize the system.

The IFA and the IFA-DFA linkages play a critical role in the process of filtering shocks for two reasons. One, they are central determinants of the efficiency and degree of completeness of the structure of financial and monetary markets; two, they also determine the quality of the policy responses in those cases in which public intervention is required because of the existence of market failures that may give rise to a disruptive adjustment.

Three features of the current global situation are indicative of shortcomings in the IFA: the persistence of international imbalances, the popularity of self-insurance strategies in the emerging world, and the succession of financial collapses that were neither anticipated nor efficiently managed within the existing regulatory frameworks. This suggests that a change in the IFA rules is necessary for financial and monetary interactions to produce a cooperative equilibrium that is superior to the observed (probably sub-optimal) global outcome.

In the aftermath of the global financial crisis of 2008, the international financial architecture (IFA) has fallen under severe scrutiny. Several reform proposals have been advanced and, in fact, some initiatives promoted by the G-20 have already been implemented. A recent United Nations Report (UN, 2009) has forcefully called attention to the significance of financial instability and crises for emerging countries and advanced a number of initiatives to reform the IFA so as to make it more stable and development-friendly. Likewise, the crisis-resolution initiatives and the changes in the regulatory framework in developed countries have had consequences on cross-border financial flows because they impinge on the incentives facing global financial institutions, governments, and investors.

The concerns about the IFA's ability to govern international financial transactions and the debates about its reform, nonetheless, are far from new. These concerns have been part and parcel of the process of a continuous increase in financial flows that took place during the "second globalization" regime, which consolidated after the demise of the Bretton Woods system in the 1970s. This is only natural in light of the existence of a dark-side that the rules and organizations of the IFA were unable to eliminate.

The consensus on the need to reform the rules that govern international financial relations so as to prevent coordination failures is firm. But the views about the content and scope of the reforms vary. This is not surprising because the process involves several countries and international organizations with different preferences, which must satisfy different constituencies. Furthermore, the proposals differ concerning the level –

regional and/or multilateral– at which the reforms should be implemented and what the organizations in charge of building the new institutional framework should be. In this regard, the post-crisis developments in the 1990s and 2000s indicate that institution building at the regional level will probably be an important component of the reform. The EU is de facto playing a central role in coordinating the responses to the crises and their consequences. The public debt crisis in Greece is a natural example. Indeed, as part of the initiatives to deal with this crisis, there have been proposals to create an European Monetary Fund. Likewise, the Chiang Mai initiative was a regional response to the inability of the IFA to ensure liquidity provision in Asia (Park, 2008).

In designing the IFA reforms, it is important to take into account the lessons learned from the crises that occurred under the second globalization regime and, in this regard, LA is a rich source of stylized facts. For one thing, since the end of the relatively calm Bretton Woods period, several LA countries have experienced at least one important crisis associated with episodes of capital flow reversals. In the context of freer capital and trade flows, exceptionally large growth collapses occurred when financial and real perturbations (for example, interest rate and terms of trade shocks) arose simultaneously.

By the late 1990s, a good number of governments and analysts in LA perceived that the rules and the organizations of the IFA were not helping to reduce volatility and prevent crises. While we can signal some cases in which the actions of international financial institutions (IFIs) contributed to managing volatility and crisis, many leading cases showed that the financial resources these institutions provided to counterbalance capital outflows and ease credit crunches did not suffice to smooth aggregate fluctuations. More often than not, the conditionality attached to the funds did not help, either.

The failures in the functioning of the IFA created incentives for LA countries to seek non-cooperative solutions to the problem of managing the consequences of external financial shocks. The evolution of the region prior to the 2008 crisis is particularly telling. To prevent the repetition of the financial stress of the 1990s, many LA countries adopted self-insurance strategies (see Fanelli and Jimenez, 2009). These strategies led the region not only to improve the macroeconomic fundamentals –fiscal and current account surpluses– but also to accumulate large amounts of international reserves. It can be argued that, as a best policy response, the self-insurance strategy leads to outcomes that are sub-optimal from the point of view of the global economy. On the one hand, this strategy has a “mercantilist” component –a higher current account surplus induced by the depreciation of the exchange rate– that does not help to reduce existing global imbalances. On the other, the strategy has a portfolio component –a higher demand for international reserves– that can reduce excessively the interest rates in those few economies that have the capacity to issue safe financial instruments, exacerbating the probability that a bubble occurs. In this sense, the IFA’s reform should aim to coordinate the actor’s responses to achieve the best outcome so as to transform self-insurance into a dominated strategy. This is no minor issue if we consider that many other emerging countries, especially in Asia, have also followed a self-insurance strategy in the last decade.

The chapter is organized as follows. Section II analyzes the meaning and scope of the IFA. It is striking that, despite the discussions on global architecture, no generally accepted definition of the IFA exists. We also elaborate on the nature of the reforms of the IFA. We will argue that the reform should be conceived as an institution-building exercise to be undertaken at the national, regional, and multilateral levels and that the way in which institutions are built has a bearing on the sense of political legitimacy and the policy ownership of the actors involved. Section III uses the concepts developed in the previous section to review the LA experience with the IFA during the second globalization. We will try to identify lessons that can be useful to clarify the problems that the international community is facing concerning the IFA reform. We focus on the role of the IFIs, standards and codes, and crisis-prevention and crisis-resolution mechanisms. We argue that the flaws in these mechanisms have had a bearing on the popularity of self-insurance in the region and, thus, contributed to the persistence of global imbalances. Section IV presents the main conclusions of the paper.

II. The IFA: scope and meaning

The content of the IFA reform agenda evolved in response to the demands for policy coordination and institutionalization that accompanied the increasing consolidation of the second globalization regime. Key to this were the repeated events of liquidity squeeze and balance of payments disequilibria, which frequently produced financial collapses in developing countries–including cases of default on sovereign debt and forced restructuring. Consequently, the search for mechanisms to prevent and manage crises and to secure international liquidity provision took increasing priority on the agenda. In this way, in the mid-2000s the IMF and the WB, the two core organizations of the IFA, were able to manage a well-defined agenda for the reform of the IFA. By that time, in reference to the ongoing IFA reform, the WB stated that the IFA "refers broadly to the framework and set of measures that can help prevent crises and manage them better in the more integrated international financial environment". In line with this, "the agenda for crisis prevention and crisis resolution deal with weaknesses in the international financial system that potentially contribute to the propensity and magnitude of global instability, hence requiring collective action at the international level. But there is widespread recognition that global financial stability also rests on robust national systems and hence requires enhanced measures at the country level as well".[2] There are a number of issues in this description of the mid-2000s IFA agenda that we would like to highlight because they are central to our analysis.

1. International financial governance and institutional change

The essential mission of the IFA is to provide effective governance structures for international financial transactions so as to facilitate the integration of the national financial systems with global capital markets while simultaneously preserving the stability of the process. Since effective governance requires appropriate norms and practices, *institutional change* is inseparable from the implementation of the IFA agenda.

The fulfillment of the IFA functions embraces rules and activities that are related to the microstructure and to the systemic dimension of financial intermediation. Dixit (2007) states that the object of analysis of economic governance embraces three elements: institutions, organizations, and collective action problems. This is because governance includes the institutions and organizations that underpin economic transactions and the collective action problems that must be solved to provide the infrastructure of rules, regulations, and information that are needed to lend feasibility or workability to the interactions among different economic actors.

The main rationale for investing in institutions and organizations for the governance of cross-border financial transactions is that these transactions contribute to increasing global welfare. The governance structures must not only reduce transaction costs at the microeconomic level, related to information and moral hazard, but also imperfections that are associated with cross-border interactions–such as spillovers (externalities) and

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[2] See http://www.worldbank.org/ifa/ifa_more.html

strategic complementarities–as well as anti-competitive practices encompassing regulations and supervision, such as free riding via regulatory arbitrage and financial protectionism, which could result in prisoners' dilemma situations.

The spillover effects that have a bearing on financial stability and international liquidity provision are especially relevant to the IFA. Should a large cross-border financial conglomerate fail, for example, the effects are likely to spill over to other national as well as international entities directly or indirectly related to it. Financial interactions may also give rise to phenomena such as contagion that are not necessarily driven by fundamentals. If the spillover is strong enough, the stability of some national financial systems could be jeopardized and, consequently, the authorities are likely to take these factors into account when designing local regulations. This creates a linkage between the DFA and the IFA. Strategic complementarities may arise when some financial centers impede the development of new regional centers because of scale economies, as in the case of ADRs in LA, which restrain the development of domestic bond and stock markets and may give rise to a low financial development trap (see de la Torre et al., 2006).

Financial spillovers have a bearing on the international liquidity provision mechanisms via their impacts on market and funding liquidity. In the case of emerging economies, liquidity shocks originating in the international system usually take the form of sudden stops and flight-to-quality events that provoke a credit crunch accompanied by abrupt falls in transactions in bond and stock markets. Under these conditions liquidity squeezes may produce solvency problems and stock prices may become very volatile because arbitrage becomes a highly risky activity. These phenomena typically put the stability of the financial system under high pressure. The market and policy responses–increases in interest rates, depreciation of the currency or the loss of international reserves–may induce severe macro disequilibria. Due to these kinds of dynamics, many authors have argued in favor of complementing micro- with macro-prudential measures, as well as with the overall macroeconomic regime (see Ocampo, 2003).

International financial relations may also create opportunities for some countries or financial centers to profit from free riding. For example, a country could relax its financial regulations in order to "steal" investors from countries in which regulations are tougher or to profit from tax evasion or money laundering. Likewise, in the event of a crisis, central banks could provide special support to domestic financial entities via guarantees or lending at subsidized rates, harming foreign competitors without access to such facilities. This was the case in the 2008 crisis.

Hence, the international community needs to design and enforce appropriate governance structures, which are able to:

(a) Facilitate international financial transactions among international parties
(b) Ensure the consistency between the domestic and international regulatory frameworks, particularly those norms that impinge on stability and regulatory arbitrage
(c) Ensure that international financial transactions improve rather than impede the provision of international liquidity and the authorities' ability to manage the macroeconomy.

The scope of the institutional reforms required to meet these goals is ample and the corresponding agenda has a multilateral and a national dimension because it is necessary to harmonize the characteristics of the local financial and monetary institutions (the DFA) so that they concur with the IFA rules and the practices that govern global financial and monetary transactions. Important inconsistencies between the DFA and the IFA could trigger market distortions and, ultimately, financial instability. This means that the implementation of the agenda calls for significant coordination and cooperation concerning the worldwide institution-building efforts, which involve a variety of international bodies of different nature and functions, not to mention the national polities[3].

The absence of a global polity poses constraints on the range of institutional options. More specifically:

(a) The existing patterns of interactions and practices in the international financial and monetary spheres may result in undesired outcomes (i.e. coordination failures, suboptimal equilibria, or crises) and this situation calls for concerted actions by the international community to improve the outcome.

(b) No world government exists, which means that:

- There is no global tax payer and thus the resources required for guaranteeing the functioning of the system must be provided voluntarily

- There are no generally accepted and "hard" punishment mechanisms to help to enforce the rules of the financial game. Surveillance and restrictions on choices concerning policies, regulations, and practices must largely be voluntarily self-imposed.

(c) There are substantial asymmetries in economic and political power within the "international community", which means that there is a risk of capture and distributional conflicts and problems of legitimacy. This may harm the ability of the international community to act collectively.

2. The IFA instruments for the coordination of decentralized institutional change

The efforts that have been made to adapt the institutions of the IFA to the changing global conditions and to ensure the consistency between the IFA and the DFA have some characteristics hat deserve mention.

(a) Some efforts were made to guarantee a certain degree of harmonization between the global and the national blueprints used in the financial institution-building works. The instruments to induce the convergence of the different DFAs toward a common design were the standards and codes issued by different bodies. To strengthen the coordination of the process, the FSF was created in 1999 (later renamed FSB) whose mission was to compile the standards recommended for the different spheres that had a bearing on financial and monetary transactions. There were also attempts to develop a "Sovereign Debt Restructuring Mechanism" intended to provide a framework for bankruptcy procedure; a code for debtors and creditors aimed at developing a market-based voluntary and flexible framework (the "Draft Principles for Stable Capital Flows and

[3] On international coordination see Meyer et al., 2002.

Fair Debt Restructuring in Emerging Markets"); and guidelines for collective action clauses to be included in bonds terms.

(b) The global and local organizations had to cooperate in the supervision and management of the institutional work in progress, as well as the overall functioning of the system. These latter activities included the supervision of the usual financial practices, macroeconomic surveillance and, eventually, the coordination of policy responses to shocks. The leading role at the global level was delegated to the World Bank and the IMF. The developed countries (say, the G7) concentrated the decision power to govern these institutions; that is, the G7 was in the driver's seat. In an attempt to create stronger ownership of reforms the G20 was created in 1999 as an instance for policy dialogue.

(c) To strengthen coordination and the sense of ownership of the IFA reforms, it was necessary to institute common values and a sense of shared missions among the participants. This role was played by the market-friendly approach to reforms. The approach evolved from ad-hoc additions to traditional IMF-conditionality during the 1980s, to the ten Washington-Consensus recommendations of the early 1990s and ultimately crystallized in the so-called second-generation reforms. The second-generation reforms entailed wide-range institutional changes, well beyond financial and monetary issues (Fanelli, 2007).

In sum, the main goal of all these activities was to coordinate a process of decentralized institutional change. But, in addition to coordination, the implementation of the IFA agenda required considerable political support on the part of national polities. The decisions power concerning the reform of domestic institutions was in the hands of the national governments and at stake was not just policy surveillance or consultation on, say, fraudulent financial practices but sizable institutional reforms. This gave rise to complex political-economy issues.

To begin with, the viability of the reforms came to depend not only on the commitment of the polities but also on their ability to build a political consensus on the convenience of reforming the DFA and investing society's resources to support the IFA. Cheap talk alone was not enough to meet the coordination needs. The IFA had to provide appropriate incentives to attract the commitment of the polities.

The incentive structure would have to be suitable to induce the cooperation of two different kinds of players. In effect, the main interest of emerging countries was to secure liquidity provision under situations of stress, financial and political support for crisis resolution, and the promotion of domestic financial deepening. For developed countries the main goals were to gain free access to financial services industries in emerging economies, to protect foreign creditors' rights, and to avoid moral hazard in lending related to liquidity provision and crisis resolution. To deal with crisis prevention the main tools were, first, surveillance –via Article IV consultation and Financial Sector Assessment Programs (FSAP)– and, second, initiatives aimed at promoting international standards and good practices. This would strengthen the transparency and accountability of the financial system. As to crisis mitigation and resolution, the main initiatives were the Contingent Credit Lines (CCL)–which were discontinued in November 2003–and the improvement of the framework to restructure the debt.

In sum, as the post-Bretton Woods regime unfolded, it became clearer that a structure for the governance of international financial and monetary transactions called for the coordination of both *policies* and *national institutions*. From this point of view, the degree of political commitment that the new regime would demand from national polities proved to be stronger than Bretton Woods rather than weaker. This is somewhat paradoxical because one important cause of the demise of Bretton Woods was its inability to coordinate national fiscal and monetary policies in the context of a fixed exchange rate regime and floating was envisaged as an exit option–an option that could make different choices of domestic policies compatible with global equilibrium. This was expected to free the polities from the constraint posed by increasing globalization. But in the end, more monetary autonomy was ultimately bought at the cost of tighter requirements for the coordination of domestic institutions. Far from freeing domestic polities from the constraints stemming from the global economy, the need to ensure global governance called for the polities to take a more active role in reforming the rules of the financial and monetary games.

In hindsight, it can be said that the results of the efforts to implement the agenda significantly differed from the expectations. For one thing, concerning crises, the IFA reforms were unable to preclude the occurrence of events of severe financial instability. Furthermore, those countries that followed the market-friendly agenda and were supposedly firmly integrated with world capital markets, such as the so-called PIGS, experienced financial instability. Likewise, despite the importance given to crisis prevention in emerging countries, the periphery of Europe repeated the mistakes of the 1990s (unsustainable debt paths and balance of payments disequilibria). Finally, the attempt to organize collective action at the global level simply failed. Two main indicators of this failure were the generalization of self-insurance strategies among developing countries and the existence of persistent current account imbalances involving both developed and developing countries. The popularity of self-insurance meant that the crisis prevention mechanisms designed by the IFIs were either useless or politically too costly. The imbalances, in turn, suggest that the system's self-regulatory mechanisms were not working efficiently (see Obstfeld and Rogoff, 2009; Obstfeld et al., 2008).

Based on this analysis of the meaning and scope of the IFA and the character of the institutional changes involved in the reforms, we will now briefly review the LA experience with the IFA during the second globalization in search of lessons that could help to face the challenges that the IFA reform currently poses.

III. From financial liberalization to self-insurance in LA

One of the most influential facts, insofar as the impact it had on LA, was the worldwide process to deregulate national financial systems and capital accounts, which gained momentum after the fall of Bretton Woods. It was accompanied by the formation of large global financial conglomerates, an ever-increasing variety of financial instruments, and strengthened foreign direct investment. Higher integration was expected not only to improve access to new sources of finance and more sophisticated risk-management instruments but also to promote domestic financial deepening. As part of these efforts one country after another opened their capital accounts and deregulated their national financial markets. Indeed, the Southern Cone countries (Argentina, Chile, and Uruguay) were world pioneers with respect to financial liberalization in the emerging world.

By the late 1990s, however, it was clear that reaping the benefits of financial integration would be more difficult than had been envisaged (see Díaz Alejandro,1985; McKinnon, 1991). A prominent obstacle was the financial opening's correlation with increased financial instability and vulnerability to external shocks (Ocampo, 2003). Domestic and international factors contributed to these disappointing results.

On the domestic side, financial deregulation proved to be institution-building intensive owing to the reasons discussed earlier. It was not just a matter of lifting financial-repression measures, such as ceilings on interest rates or mandates on credit allocation. It was necessary to re-build the entire DFA so as to adapt the institutions (i.e. legal infrastructure and regulations) and organizations (i.e. regulatory and supervisory bodies) to a deregulated environment (Ocampo and Griffith-Jones, 2009, Fanelli, 2008).

The integration with global capital markets via capital account deregulation was also problematic. Capital flows proved to be volatile, pro-cyclical, and prone to sudden stops. This was related with two facts: one, the distorted incentives created by ill-designed institutional frameworks which gave rise to unstable liquidity conditions, excessive current account deficits, and recurrent public debt sustainability problems (see Ocampo, 2003; ECLAC, 2008); two, the inability of the IFA to internalize the externalities created in the deregulation process, which took the form of contagion and regulatory arbitrage.

After dealing with the "lost decade" triggered by the debt crisis of 1982 and the turmoil associated with the Mexican financial crisis of 1994-95, the LA policy makers were fully aware that the deregulation process tended to generate systemic vulnerabilities. The following stylized facts are representative of the types of phenomena that were observed in the region:

- Financial stress, associated with sudden changes in risk aversion and domestic de-leveraging, caused strong output losses and frequently induced long-lasting deleterious effects on the aggregate investment rate.
- Currency and term mismatches played a role in nurturing financial disequilibria.

- The government acted as insurer of last resort and the fiscal imbalances provoked by the bailout of the banking system tended to erode public debt sustainability and ultimately impinged on political legitimacy.
- The authorities were unable to implement appropriate anti-cyclical policies in a context in which capital flows tended to behave pro-cyclically.

In light of these facts, the authorities in the region began to include macro-prudential rules in the regulatory framework, together with more traditional micro rules, such as capital adequacy. One important goal was to induce reductions in the share of dollar-denominated liabilities held by both the private and public sectors. In an effort to reduce fiscal vulnerability, many countries introduced fiscal responsibility tools aimed at eliminating pro-deficit bias. The most sophisticated, like Chile, introduced structural fiscal rules oriented to smoothing the pro-cyclical patterns, which proved to be inherent to deregulation in a context of incomplete and imperfect financial markets. This country, together with Brazil among others, also tried to use capital controls to smooth the effect of pro-cyclical capital movements.

In sum, the experience with deregulation revealed that it had more to do with market creation than with market liberalization to the extent that it was necessary to build the institutional foundations of financial markets. Neither the LA governments nor the IFIs pushing for liberalization had sufficient expertise concerning this type of institutional change. It is no wonder that McKinnon, who had inspired the reforms in the 1970s, had stated a decade or so later that liberalizing markets was analogous to “walking through a minefield” (McKinnon, 1991). It is also true, however, that LA countries showed some ability to learn from experience and began to develop the macro-prudential and macroeconomic tools to survive their minefields.

Moreover, an increasing number of LA policy makers and academics reached the conclusion that “something” was wrong” with the *governance* of *international* financial transactions and/or the international monetary system. For one thing, domestic fundamentals alone could not account for episodes of contagion and sudden stops. In line with this conclusion, there were increasing demands for the IFIs to improve the mechanisms for international liquidity provision and the conditionality attached to IMF assistance. Four demands were forcefully voiced: one, liquidity provision under sudden stops and contagion should be timely and adequate; two, the size of assistance packages should take into consideration that liquidity requirements are higher when the capital account is open and private capital flows are pro-cyclical; three, the IFIs should not impose tight fiscal adjustments under stress, which accentuates pro-cyclicality; and four, conditioning the “global community’s” financial assistance to fiscal adjustment in a context in which unemployment and poverty are rising should be avoided because it undermines political legitimacy.

These arguments, however, were only partially shared by the IFIs. On the one hand, the size of the assistance packages was increased to match the needs of economies that had liberalized the capital accounts. The stronger financial effort was justified because it was in the interest of all participants in the global markets to avoid contagion and spillover effects. But, on the other hand, the standard view continued to hold that the main sources of distortions and instability were weak *domestic policies*. A key mission of the IFA was, therefore, to check for moral hazard. Loan conditionality had to be tough to deter national authorities from implementing bad policies or distortionary regulations, such as capital controls which could jeopardize foreign loans or the forced restructuring of debt obligations. In this way, conditionality had to perform a double duty: to provide liquidity under stress conditions and to act as a punishment to deter moral hazard. Striking a balance between these two objectives was not easy and the weight given to each changed substantially in line with changing political visions of the G-7.

The Mexican rescue package is an important example of this trade-off. The international community assisted Mexico with a sizable "rescue package" but the authorities were required to pledge assets as collateral for external loans and to launch tough policy reforms. The primary cause of the problem was diagnosed as ill-suited Mexican policies rather than the flawed governance of international financial transactions. The goal of financial assistance was to minimize the externality costs associated with bad domestic policies and to induce the deviant country to implement policy reforms. An additional positive externality was to send signals to other would-be deviants that bad policies would be punished severely under the rules of the IFA.

The developments in Asia in 1997, however, strengthened the argument that something was wrong with global governance and that, consequently, the approach to crisis prevention and resolution had to be updated. Three features of the Asian crises deserve mention in this regard. First, the 1997 Asian turmoil was largely unexpected, suggesting that both global private financial decision makers and the IFIs' early warning systems were unreliable. Second, the crises occurred in a region that had been systematically praised for the quality of its pro-growth, market-friendly, and reasonable macroeconomic *policies*. Hence, it was only natural that other factors, in addition to domestic policies, had to be considered in assessing vulnerability to shocks. Financial regulations and supervision and weak corporate governance were prime suspects together with the soft fixing of the exchange rate. Third, unlike the LA experience, high growth had been the rule rather than the exception in the countries hit by the crisis. Hence, the costs of the pro-cyclical adjustment policies associated with IFIs' conditionality were more apparent than in LA in detriment to the sense of legitimacy and policy ownership. Indeed, the Chiang Mai initiative can be interpreted as an effort to strengthen policy ownership and improve liquidity provision mechanisms by means of regional financial cooperation[4].

These facts led the international community to widen the focus: The rules that govern international financial transactions began to be considered part of the problem rather than the solution. Likewise, it was increasingly recognized that political legitimacy mattered to the IFA and some very timid steps were taken to strengthen both the voice and decision power of emerging countries. The creation of the G-20 as a forum to facilitate open discussion between industrial and emerging-market countries was

[4] At the ASEAN+3 Summit in November 1999, regional leaders agreed to enhance "self-help and support mechanisms in East Asia" through the ASEAN+3 framework. At the ASEAN+3 Finance Ministers' Meeting in May 2000, finance ministers agreed to promote the Chiang Mai Initiative to establish a regional financial arrangement to supplement the existing international facilities.

expected to contribute to "strengthening the international financial architecture and providing opportunities for dialogue on national policies, international co-operation, and international financial institutions". With regard to decision power in the IFIs, a process to change the governance of the Bretton Woods institutions was initiated, recognizing a problem of representation.

In sum, a consensus began to take shape on the following points: one, the importance of reforming the IFA and the fact that global problems called for global responses; two, in a world of sudden stops and contagion, the conditionality attached to liquidity provision mechanisms should not impede a timely response; three, institutions matter to the governance of domestic and international financial transactions and, therefore, the global and national institution-building capacity must be strengthened. Furthermore, the Chiang Mai initiative suggested that the institutional works would probably include a regional layer.

This process, however, rapidly lost momentum, in part as a consequence of the Russian crisis of 1998. In Russia, the attempt to stabilize the economy failed because a good part of the financial support stemming from the IFIs was channeled to finance capital flight and to favor specific stakeholders. Those who had forcefully called attention to the role of moral hazard had a strong case. The Argentine crisis in 2001-02 was further interpreted as evidence against rescue packages and the difficulties to commit. Overwhelmed by the demise of the convertibility regime, Argentina defaulted on its debt obligations in December 2001 after receiving a rescue package from the IMF at the beginning of 2001.

Krueger (2003) well represents the more pessimistic view that arose after these episodes. She reached the conclusion that the IMF's primary mission was crisis prevention and only for occasional cases–where crises cannot be prevented–crisis resolution. In line with this approach, the discussion about the new architecture lost momentum and was gradually supplanted by a renewed emphasis on the need to institute a "sustainable" domestic regime, which now included not only macroeconomic and financial policies but also the financial regulatory framework. In this new context, the IMF would oversee the internalization of the standards and codes promoted by the FSF, embracing two key areas: enhancing transparency and accountability and strengthening domestic financial systems. Although the institution-building tasks involved had been plagued with idiosyncratic difficulties, it was expected that the actions at the national level were made in collaboration with the joint Bank-Fund FSAP and the Reports on Standards and Codes (ROSC) initiative. The efforts to design appropriate packages for liquidity provision and crisis mitigation should shift the focus toward the "orderly restructuring" of sovereign debt, and the design of a set of rules to facilitate the resolution of conflict between creditors and debtors (Krueger, 2003). In this way, the still largely unsettled question of how the IMF and other IFIs should act to generate liquidity and facilitate debt restructuring in a crisis situation and thus avoid economic collapse in a given country was left aside.

Under these circumstances an LA country–or, indeed, a country from any other region–was finding it highly difficult to know how much help it could expect were it to suffer from contagion or a sudden stop. The responses of the IFIs' authorities for liquidity provision in the Turkish, Argentine, Uruguayan and Brazilian crises showed marked differences. Uncertainty was further fed by the lack of advancement in the proposals of the orderly restructuring of debt and conflict resolution. In 2003, Krueger recognized that, after a year of vigorous and constructive debates on the need to improve arrangements to resolve financial crises, and in particular, to establish the tools to restructure sovereign debt, this remained a "controversial topic" (2003). The only novelty regarding this was that some countries introduced collective action clauses in their new debt issues. These were certainly too weak a response to the coordination failure problems posed by debt restructuring and, more generally, to the need for clearer and transparent rules for the governance of international financial transactions. It is no wonder that the IMF itself lost weight in the international arena. In the years preceding the 2008 crisis, many countries reimbursed the loans and the institution credit portfolio shrank.

The Progress Report on the IFA produced by the World Bank Staff in 2005 (World Bank, 2005) is very telling with regard to the lack of substantial progress concerning the governance of international transactions. It is interesting that this Report also called attention to a number of new developments in the emerging world. The Report stressed that emerging markets have become net capital exporters and that two key foundations behind such a pattern were: (i) a noticeable shift from external to domestic borrowing in public debt across a broad range of emerging markets, reflecting movements of existing debt; and (ii) the accumulation of large amounts of international reserves by several emerging markets to self-insure against financial crises, reflecting the attempts to prevent nominal exchange rate appreciation in the face of increasing capital inflows. The Report expressed concerns about the costs of this new strategy: reserve accumulation was constraining growth through investment levels below trend.

This brief review of the experience of LA and other emerging countries with the IFA suggests a number of conclusions that are relevant to our analysis. One, in the first half of the 2000s, the IFIs favored the diagnosis that the global problems–liquidity provision, contagion–would stem from individual policy responses. The mission of the IFIs was to help emerging countries to internalize the global rules of the game. The institutions were global in the sense that they were being replicated everywhere on the basis of a shared blueprint. They were not global in the sense that they had to address global coordination, beyond the mission of addressing the cheap-talk-like pre-coordination activity of spreading the same standards and codes everywhere. In the case of LA countries, a macro regime was one more factor: inflation targeting plus fiscal rules for large countries and hard pegs or dollarization for the smaller ones that were more integrated with the USA or with an inflationary past. This assumed that liquidity and crisis resolution were not the primary problems to be addressed. If the FSF-recommended standards and codes were internalized, there would be a market-driven solution for the problems of debt restructuring. Two, emerging markets did not perceive that the coordination game that they were playing was one in which cheap-talk could help. When no country took the Contingent Credit Line and the IMF let it expire in 2003 without replacing it with a more effective liquidity provision mechanism, the IFIs de facto signaled that timely liquidity provision was not part of the payoff in the global game. But if the carrots (a timely provision of liquidity) did not exist, why should the country accept the threat of a stick (the restrictions attached to the IMF conditionality and the overseeing via FSAP) instead of trying a non-cooperative response (self-insurance), which leaves much more policy space available? In a nutshell: the IFIs' change of paradigm at the beginning of the 2000s induced a dramatic change in the pay-off matrix and it is no wonder that the equilibrium outcome also changed: under the new conditions, the IFA and the G-20 languished, ritually repeating–communiqué after communiqué–the benefits of strengthening policies and institutions in emerging countries.

There were indications, however, that either the outcome was unstable or some policy makers were simply mistaken. That is, their responses were not the best given the constraint posed by the IFA (i.e. the lack of liquidity provision facilities). The concern about the stability was motivated by the persistence of the global imbalances (see Blanchard and Milesi-Ferretti, 2009). The worries about the policy response stemmed from the fact that, while Asian and LA countries responded non-cooperatively, implementing a self-insurance strategy, the European periphery promptly increased its vulnerability, repeating some of the mistakes made by LA and Asia: currency and term mismatching, large current account deficits, and misaligned exchange rates. Obviously, not everybody was right: if global financial governance and the IFA were as flawed as they had been, the strategy of the European periphery was unsuitable and the self-insurance strategies followed in LA and Asia made sense. On the other hand, if the existing governance structures were basically fulfilling their functions, the latter strategy was too conservative and costly.

With the benefit of hindsight, we can hypothesize that the pay-off of the self-insurance strategy was higher. One indication of this is that the LA countries were far better prepared to resist contagion than in the past precisely because they played the non-cooperative self-insurance strategy while there was a succession of instability episodes in the European periphery. Another indication is that many European countries have received assistance from the IMF, who had to return to its traditional function as lender of last resort. As was the case in LA and Asia in the nineties, the IMF organized rescue packages for several countries (see IMF, 2009a).

The superiority of the self-insurance strategy vis-à-vis individual countries does not make it optimal concerning global welfare. It is a costly strategy, which generates negative externalities in terms of financial and trade imbalances. This suggests that there is probably room for improvement. But this means that the agenda for the IFA reform needs revitalizing. Certainly, that the G-20 is now much more proactive and that the IMF has launched new facilities for timely liquidity provision are clear signals that the reform agenda that derailed in the early 2000s is now on track. Of course, a highly counterfactual but still relevant question is what would have happened with world imbalances if the IFA reform agenda had not been downplayed in the early 2000s.

The pre-2008-crisis view of the IFA contrasts with the current view of the organizations that manage the IFA (see, Blanchard et al., 2009; Claessens et al., 2009; IMF, 2010; Mateos et al., 2010; Ostry et al., 2010). For example, the IMF (IMF, 2009b) has drawn the following "initial lessons"– the crisis has revealed important flaws in the current global architecture. The document focuses the criticism on four key areas:

(1) *Surveillance of systemic risk,* which needs to be reoriented to ensure warnings are clear and to provide practical advice to policy makers; (2) *International coordination of macro-prudential responses to systemic risk.* It is necessary to improve the arrangements that govern collective policy decisions, involving forums such as the International Monetary and Financial Committee, the Financial Stability Forum, and the various "Gs"; (3) *Cross-border arrangements for financial regulation*. It is necessary to avoid regulatory arbitrage and a repetition of the "go-it-alone" responses seen in this crisis; (4) *Funding for liquidity support or external adjustment.* Public funds from the Fund and others are needed to help countries weather short-term liquidity strains, or to smooth necessary adjustments from unsustainable external trajectories. Given the size of international transactions, these resources should be augmented, and processes for providing short-term liquidity better defined.

Indeed, the bulk of these lessons could have been drawn from the observation of the Latin American experience or, for that matter, of other important emerging regions, notably Asia. But, as we have seen, at the beginning of the 2000s there was a marked shift in the IFIs' view concerning collective action. The problem of limiting moral hazard in lending received much more attention as compared with other goals, such as the provision of international liquidity and crisis resolution. The IFIs did not pay sufficient attention to the problem of the recurrence of "disruptive adjustments" and its implications for global inefficiencies. This led to an incorrect diagnosis and, therefore, to incorrect conditionality.

IV. Conclusions
On coordination and global institution building

Undoubtedly, the purpose of restoring global financial stability and overcoming the threat of a worldwide depression is the main motivation behind the current international community's efforts to improve the IFA. The G-20 declaration in the Washington summit is particularly telling in this regard: it states the group's determination to enhance the cooperation with respect to two goals: "to restore global growth and achieve needed reforms in the world's financial systems". Moreover, the G-20 declaration provides clues about why global, coordinated actions are required rather than individual initiatives: "a broader policy response is needed based on closer macroeconomic cooperation to restore growth, avoid negative spillovers and support emerging economies and developing countries". From our analysis it follows, however, that the fulfillment of these goals will face significant obstacles. Based on the Latin American experience, we have highlighted the role of institutional change, the large scope of the reforms in the governance structures involved and the problems of defining an incentive structure that can promote collective action at the global level. We will now discuss some conclusions referring to these issues, trying to pinpoint the possible contribution that regional policy dialogue and arrangements can make to reform the IFA.

The current IFA has failed to align the interests of global players and avoid the sub-optimal outcomes associated with self-insurance strategies and the imbalances that fed the crises. It failed to deliver what is essential: an effective framework for the governance of international financial transactions.

One key strategic flaw of the approach to the IFA during the second globalization was that crisis-prevention, as well as crisis-resolution, initiatives emphasized the emerging economies' side of the problem to the detriment of the treatment of the developed-side distortions.

The crisis-prevention initiatives focused on reforming the emerging countries' DFA and overlooked the developed counterparts. More specifically, beyond cheap-talk, the bulk of the efforts was biased toward creating incentives for developing countries to reform their institutions following the FSF standards and codes and the IMF-WB guidelines for macroeconomic policy reforms. The main strategy to provide incentives was to tie IFIs' credit to the implementation of "structural and policy reforms". With respect to developed countries, it was basically assumed that both the incentive structure facing international conglomerates and the domestic policy and regulatory frameworks were suitable to produce a global cooperative outcome, provided that emerging economies succeeded at reforming their DFAs. The G-7 DFAs were deemed appropriate not only to check for moral hazard in financial transactions but also to avoid free riding in the global arena (via regulatory arbitrage) and to internalize spillover effects (contagion).

The efforts to create mechanisms for crisis resolution and liquidity provision under stress were also biased toward emerging markets. For example, no contingent plans had been designed to address the occurrence of a sudden stop or a credit crunch in developed markets. A sovereign debt restructuring mechanism and collective action clauses were tailored responses for debt-default events in the developing world.

Hence, those global actors who had sufficient decision power to influence the design of the IFAs' rules acted as if they could achieve cooperation and supersede the observed sub-optimal outcomes by changing the rules of the game for just one of the parties. Of course, this would be a sensible strategy if emerging countries' authorities acted as delegates of developed countries. But in a world of sovereign states and governments with differing constituencies, this was not the case. In the post-colonial world, "hard" enforcement instruments are very scarce and costly and the rules of the game must largely be self-imposed. It is a world in which only "soft" enforcing mechanisms–such as reputation costs, shared "global" values or the menace to cut access to contingent liquidity facilities and cheap credit from IFIs–are available. Therefore, it is an environment in which commitment is difficult and thus coordination failures and free riding are difficult to overcome.

The ultimate result of the one-sided and biased strategy for building the institutions of the global economy was that the rules of the game failed to induce the cooperative global outcome. Under the flawed IFA of the early 2000s, the strategic choice of major LA and other emerging countries was "self-insurance", making their contribution to the suboptimal global imbalances. Meanwhile, large global financial conglomerates and deficit-prone developed countries were playing in an institutional environment that was permeable to moral hazard.

Global institutional change is necessary, but how can institutional change occur? There are basically two alternatives. One is that, given the post-crisis conditions, the new regime results spontaneously from the strategic interactions of the national, regional and multilateral players involved. The recent crisis, nonetheless, does not leave much room for optimism: it suggests that there can still be instability factors at work and, as a consequence, the global economy could end up in a low-equilibrium financial trap in which international financial flows are reduced to a minimum. The second alternative is voluntary reform, that is, the introduction of new rules for the governance of financial flows so as to change the structure of incentives that led to the crisis. The problem with this alternative is that no formal international polity exists to set the goals that will be pursued with the new rules and enforce them. Under these conditions, the problem of designing the reform of the IFA is, essentially, to find a set of rules that all the players can willingly accept, given the existing distribution of political and economic power. The resulting institutional framework should be self-enforcing.

Proposals have been advanced to change the rules of the game but it will be difficult to reach an agreement about new rules without taking into account their ultimate distributional effects. Different rules of the game have different distributional consequences and the consensus on this cannot be taken for granted. To be sure, it is central to ensure that the strategic interactions that took place in the global economy produce the most efficient equilibrium outcome possible. But the problem of designing, implementing, and enforcing an appropriate set of rules is relevant only if there is at least some political consensus on the nature of the desired outcome.

In light of the current imbalances and financial disequilibria it is clear that those reforms that can help to deal with disruptive adjustments should be given priority on the IFA agenda. However, it must be taken into account that a sense of policy and institution ownership is vital for the countries involved to accept the rules of an IFA designed to induce the cooperative global equilibrium. An effective way of making the sense of ownership stronger within the international community is to strengthen the participation of developing countries in the governance of the organizations that design and manage the rules and organizations of the IFA. This indicates that strengthening ownership will come at a price for those countries that concentrate today's global decision power: emerging countries will seek to define rules for the global game that are more suitable to their goals, which includes achieving domestic financial development and, ultimately, catching up with the developed countries' per capita GDP.

Of course, there will also be benefits. To begin with, ownership is a key ingredient in political legitimacy and a legitimate IFA is more likely to induce self-enforcing. Second, it is in the interest of developed countries to create conditions that are beneficial for growth in the emerging world. According to the IMF projections, emerging countries are likely to explain the lion's share of future global growth. Third, improving institutional quality and reducing volatility in the emerging world will open new investment opportunities. If institutional spillover effects were internalized, the world's investment opportunities would improve. Many profitable investment projects are currently unexploited because of appropriability problems or excessive risks associated with macro volatility and disruptive adjustments. Opening new opportunities can help industrialized countries to allocate their savings better, reducing the occurrence of new savings gluts in the developed world. The depression of investment in Asia and other emerging economies after the succession of crises in the 1990s may have contributed to feeding global imbalances and bubbles in the 2000s.

The fact that the rules for the global governance must be self-enforced brings to the fore the problem of political legitimacy. It is important to create (or improve the existing) institutional spaces that can be instrumental at undertaking negotiations and harmonizing the goals of countries belonging to different categories. We have emphasized the differences between the G-7 and emerging countries but that is just one possible cleavage. Dialogue and the formation of coalitions at the regional level based on existing arrangements may be a useful intermediate step to harmonize the interest of the countries involved in the global game.

The problems associated with collective action aimed at institution building and policy coordination suggest that the IFA reforms must adopt a systemic institutional approach embracing the national, regional, and multilateral instances. The regional platform for building the rules of the global game can show comparative advantages in building policy ownership and political legitimacy. The limits of the authority and mandates of the organizations that must apply the rules of the IFA are inherently fuzzy. The Chiang Mai and the European experiences suggest that regional arrangements may contribute to building the IFAs' rules.

Legitimacy is central to policy ownership and this, in turn, is central to preventing free riding and regulatory arbitrage, which are public enemies of coordination. This is where regions have a role. The IFA has primarily to do with rules, but it also has to do with organizations to coordinate and manage the global system.

The development of stronger regional centers based on promoting financial deepening via regional integration can help to avoid an important flaw in the functioning of the system, which was evident in the pre-crisis period. Note that one cause of the reduction in the interest rates that fed the bubble was the increase in the demand for safe assets. These assets are basically "produced" by the USA, whose markets are deeper and more liquid. This means that, under the current system, a liquid and safe global portfolio cannot be well diversified because there is only one seller of such assets. By increasing market liquidity the development of regional financial centers could help investors to diversify their portfolios.

Among the issues to be treated at regional levels are: tools to deal with contagion that usually have a regional component; swap agreements with the central banks that issue reserve currencies could be negotiated so as to cover regional needs under contagion; financial support for development can be channeled through regional banks; and common pool arrangements can contribute to saving valuable resources.

Three policy goals associated with the building of the DFA from the Latin American region's point of view are: achieving deeper integration with the global economy, developing financial intermediation in a stable environment, and preserving macroeconomic stability. These goals are shared by the entire region and, therefore, regional initiatives to promote these goals should, in principle, be easy to develop. The three largest economies of the region participate in the G-20 and this could be a valuable instance for policy dialogue with the G-7 so as to ensure a balance between development goals and the need to check for moral hazard in lending, avoiding the biases that led to self-insurance. Efficiency, distribution, and institution-building are typically separate factors in economic analysis. But they are difficult to separate under the current circumstances. To solve the existing coordination failures and achieve a favorable global outcome, emerging countries must have incentives to participate. This means that the benefits provided by the new IFA in terms of growth and stability must exceed the benefits of the self-insurance, "isolationist" strategies. If the rules of the game were already defined, it would be easier to calculate the payoffs associated with alternative strategies. But the rules of the game are being defined now. Consequently, it is not just a problem of choosing between available strategies but of trying and defining the rules themselves. The ability to participate in establishing the rules of the game is directly related to the political importance of the country or region. Some actors will be leaders; others will be followers. Thus, it would be useful for the region or segments of the region to explore the option of coalitions to compound the political leverage of the group. The political economy constraints matter when it comes down to delineating feasible solutions to the coordination problems that the international economy is facing.

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