The Reconstruction of the International Financial Architecture: Keynes' Revenge?

Author(s): André Cartapanis and Michel Herland

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The reconstruction of the International Financial Architecture: Keynes' revenge?

André Cartapanis and Michel Herland

CEFI, Université de la Méditerranée

ABSTRACT

Faced with the gravity of the financial crises which occurred in Mexico and, above all, in Asia, the objective of the new financial architecture as defined by the G7 and the IMF is to control international financial instability. However, many questions remain. Is it merely a question of improving the transparency of information in order to encourage better financial practice or of introducing much stricter rules while accepting the principle of limiting the international mobility of capital? If such questions arise, it is because there is no theoretical consensus over the dysfunction that was observed on the international financial markets in the 1990s. Paradoxically, this leads us to reconsider the work and theoretical heritage left to us by Keynes. Discussions about international monetary and financial governance recall the debate raised by Keynes, first of all in his *Treatise on Money*, about improvements to the gold standard system, and then when preparing for the Bretton Woods Conference. Could this new financial architecture not be seen as Keynes' revenge? In fact, the new architecture is a working compromise which brings together neo-Keynesian and neo-liberal principles but which cannot fully answer the challenges of systemic risk.

KEYWORDS

International Financial Architecture; Keynes; neo-liberalism; financial crises; International Monetary Fund.

INTRODUCTION

Faced with the gravity of the financial crises which occurred in Mexico in 1994 and, above all, in Asia in 1997, before spreading to all the international capital markets, the question of the new financial architecture is a topical one. Many reports have been written about the subject from a normative perspective (Bergsten *et al.*, 1999; Eichengreen, 1999; Hills *et al.*, Council on Foreign Relations Independent Task Force,

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1999; Metzler, International Financial Institution Advisory Commission, 2000; Goldstein, 2001), and the authors of such reports focus on the problems of the governance of international monetary and financial Institutions. Wyplosz and the International Center for Monetary and Banking Studies in Geneva (1999) have called for a radical reform of the articles of the IMF in order to give it greater accountability and autonomy in relation to governments. Concerning the matter of the international lender of last resort, IMF experts, first and foremost Fischer (1999), have drawn up the necessary conditions for the IMF on behalf of governments, to carry out this function in accordance with these conditions. This is in contrast to Aglietta and De Boissieu (1999) who consider that the BIS and the central banks together with supervising the international banking system and payment systems, are in a better position to carry out this role. In a more radical way, some post-Keynesian economists such as Eatwell and Taylor (1998) propose the replacement of all the current Institutions (IMF, World Bank, BIS . . .) by a single *World Financial Authority.*

As regards governments, under the aegis of the G-7 and the G-22, ad hoc working groups[1] were set up in April 1998 to put forward proposals on the basis of which the Finance Ministers of the G-7 agreed on a common declaration at the Cologne summit in June 1999. This declaration highlights the principles which could improve and reform the architecture of the global financial system and forms the basis of the mandate given to the IMF to draw up precise measures. A number of recent IMF reports[2] indicate that progress has been made in this area, but in relation to institutional forms, the political framework and the delegating of responsibility for the implementation of the new architecture, the Declaration of the G-7 in June 1999 clearly stated the principle of status quo. For the American government, which is the real architect of the current discussions and had a decisive role in defining the mandate given to the IMF, it is simply a question of adding a new chapter to the Bretton Woods Agreement without modifying its basic principles. Above all, it is about encouraging new practices and improving the transparency and the supervision of the markets especially by entrusting the Financial Stability Institute,[3] created in 1999, with the task of training experts and high-ranking government servants in emerging countries.

Under these conditions, it is highly unlikely that the new architecture will adopt the form of a series of rules leading to a new system that would impose itself on the international community as a whole, which is what happened when the IMF was created in 1944. In these terms, the international financial architecture is seen as a pragmatic solution to global financial instability and not as an institutional advancement regarding the mode of monetary and financial governance on a global scale.

However, the project for a new international financial architecture reveals a shift in doctrine towards the Washington consensus.[4] The Asian crisis, due to its violence, its context and ripple effects, has brought into question a number of supposedly acquired principles regarding the underlying basis and the efficiency of financial liberalization.

But is it true to say that other principles have been implemented? It is striking to observe the growing importance of the notions of confidence, liquidity, the imperfection of financial markets, and mimetic contagions in the current debates. In the same way, the discussions about the governance of international monetary and financial Institutions recall the debate raised by Keynes both in his *Treatise on Money*, about improvements to the gold standard system, and when preparing for the Bretton Woods Conference.

Could one not, therefore, see in the discussions about the reform of the international financial architecture Keynes' revenge? Yet many people see the mark of neo-liberalism in the project of the new global financial architecture, despite the reappearance of governments and public rationale in the governance of international financial markets.

This article is devoted to the theoretical principles upon which the new architecture seems to have been built. In section 1, discussions about the international financial architecture are set in the context of the financial crises of the 90s. The basic principles of the new financial architecture are then presented as defined by the Group of Seven in 1999 and enforced since then by the IMF. In section 2, we focus on the theoretical foundations of Keynes on which this project is based, albeit in part. In section 3 and in the conclusion, we show that the new measures for international financial governance are an ambiguous and unfinished compromise imposed by the US, the implementation of which cannot provide a fully satisfactory solution to systemic risk.

THE RECONSTRUCTION PROJECT FOR THE INTERNATIONAL FINANCIAL ARCHITECTURE

The Asian crisis in 1997 and 1998 was not just a period of financial instability that the world economy goes through regularly but a crisis of the whole financial system. Both the extent of the crisis and the way it spread to the rest of the world capital markets created an awareness of the risks that financial liberalization has for the stability of the global economy. This has justified the urgent need for a new international architecture.

A context of systemic crises

Throughout the 1990s, the number of crises that have had international repercussions increased. Rarely in the course of history has the international financial markets experienced such violent adjustments as those that have taken place in recent years: considerable tension on the bonds market in 1994; the Mexican crisis between December 1994 and February 1995; the collapse of Baring Brothers in February 1995; the Asian stock market crash in the autumn of 1997; financial difficulties in Russia from May to August 1998; the crisis in Brazil between November 1998 and January 1999; the crisis in Turkey and in Argentina at the beginning of 2001 and so on. On these occasions, several things became obvious, in particular the fragility of the international financial systems and the rationality of the investors which could lead to an increase in general insecurity and to a rapid transformation of a local shock into a global liquidity crisis.

These anomalies cannot be attributed to financial competition *per se*, but rather to the fact that the liberalization of capital movements has usually resulted in a sharp increase in liquid liabilities and notably in short-term currency borrowing through the intermediary of the banks. This has made the economies concerned much more vulnerable to a change in the state of confidence, or to a shock in the evaluation of risk by international investors. The Asian crisis is a perfect illustration of this type of scenario. Because of this, the international mobility of capital accentuates and multiplies the sources of instability and crisis, especially in developing economies which are still marked, and have been for years, by very close links between banks and governments, the latter guaranteeing the stability of the financial commitments.

However, the Asian crisis has been interpreted in various ways. The crisis was a response to a dramatic increase in risk as perceived by international investors resulting in a dramatic loss of confidence. But was this loss of confidence justified by the fundamentals in Thailand, Indonesia, Korea or in the Philippines? Some would say it was. They consider this crisis the culmination of an unsustainable deterioration in the macroeconomic fundamentals and the inevitable consequence of inappropriate policies, even if the scope and extent of the crisis in the region indicates a lack of discernment and an irrational knock-on effect, in the context of the fragility of the domestic financial markets (Dornbusch, 1998; Corsetti *et al.*, 1999). On the other hand, for other economists, the Asian crisis is seen more as a wave of panic which cannot be directly linked to a sudden worsening of the macro-economic imbalances. It should rather, they say, be analysed in terms of self-fulfilling prophecies or sunspots (Krugman, 1998). Whereas the crisis of the peso in Mexico in 1994 and 1995 was interpreted in terms of the unsustainability of the current account deficits, the Asian crisis in 1997 and 1998 led economists to give greater importance to factors of vulnerability. They extended the variables which might explain the crisis to include weaknesses in the financial and banking systems and in the area of prudential standard, referring to the illiquidity crisis brought about by the self-fulfilling expectations of international investors.

Most Asian countries had more or less balanced budgets. They did not have expansionary monetary policies that could be considered as irresponsible and their rates of inflation were not very high. They were not experiencing a rise in current accounts deficits which seemed to be at an acceptable level. Finally, none of them, before the crisis, had the kind of high unemployment levels that might have subsequently encouraged them to pursue a more clearly expansionist monetary policy requiring a relaxing of their exchange objectives.

The Asian crisis is not, therefore, a conventional currency crisis. It is more like a deep financial crisis containing all the ingredients of a systemic crisis. Although it has been defined in various ways (De Bandt and Hartmann, 2000; Aglietta et Moutot, 1993), the notion of a systemic crisis obviously involves the spread of a local shock on a regional or global level. But it also includes factors that are not taken into account by those who support the theories of the efficiency of the markets or rational expectations: failure to see disaster coming, radical uncertainty, an excessive preference for liquid assets, mimetic effects, global interdependence and the spreading of the crisis among the different types of financial markets (exchange market, bonds market, stock markets, credit market) or on a global scale.

Of course, sudden changes of opinion on the financial markets are rarely a response to an unreasonable analysis of a country's situation or a particular kind of asset. However, the overshooting of the markets, besides the vulnerability that it causes for the traders themselves, very often reveals the short-sighted nature of forecasts and a real lack of discernment in the way they are used (Cartapanis, 1994, 1998). If a cause for worry appears on a market, though it may be considered to be of short duration or even to have no objective justification in the eyes of the traders, predictions are established which spread a feeling of mistrust towards other markets and other countries in the form of volatility spillovers or shifts in the price of assets.

All this explains why the Washington consensus which advocated the rapid modernization of financial systems, the extension of securitization, the generalization of the external convertibility of currency, and the liberalization of the modes in which interest rates are fixed, is no longer in fashion even at the World Bank and the IMF. There are two types of argument for this: theoretical arguments and empirical ones. The argument in favour of financial liberalization was based on the theory of the efficiency of financial markets and on the assumption that information was totally accurate. However, when information is not perfectly reliable and markets are incomplete, unbridled competition is no longer *pareto-efficient* and government intervention must be maintained in order to control certain sources of inefficiency or fragility (Stiglitz, 1998, 1999). These: adverse selections and inordinate risk-taking in the presence of asymmetrical information, are accentuated by the conviction of a lender of last resort intervention, which raises the problem of moral risk; uncertainty over the efficiency of the modes of governance of the banks coupled with short-sightedness imposed by the shareholders; the risk of a herd mentality causing the irrational spread of speculative crises and banking crises and so on. At the same time, experience shows that the liberalization of international capital movements significantly increases the risk of a financial crisis although there is no proven correlation with the level of investment or the rate of growth (Rodrik, 1998).

This overall situation justifies the fact that the architecture of the global financial system is indeed today a relevant issue.

The basic principles of the new architecture

On the basis of the technical reports submitted in October 1998 by the three working groups which began work in April of that year under the aegis of the G-22, the Finance Ministers of the G-7 at the Cologne summit in June 1999 agreed on a common declaration. This declaration lays out in detail the principles which could improve and reform the architecture of the global financial system. We will use the text of this declaration to describe the options which have been the object of a political compromise among the most developed countries.

We cannot give a detailed account of the 60 points drawn up in the G-7 declaration. Some of them put forward a series of options or possible measures to be taken in the areas of exchange regimes, action to be taken by the IMF and the World Bank, and prudential standards which could be imposed on financial intermediaries. We will simply lay out the basic principles outlined implicitly or explicitly by the Finance Ministers of the G-7.

From the outset, the necessity of reducing financial risks and improving international cooperation is presented as an essential measure which would optimize the advantages of the process of globalization and international financial integration. This greater stability does not require the creation of new financial Institutions but it does require greater responsibility on the part of governments both in their macro-economic policies and in the definition of clearer rules of the game for markets and traders.

In each of the priority areas, principles underlying the reforms are laid out and then political recommendations are put forward including the definition of the tools required to attain the objective of financial stability. In spite of the formal and sometimes rather unconventional nature of this type of declaration, the basic options adopted by the G7 can be grouped under four main principles.

(1) *It is necessary to reinforce the transparency and the quality of information in order to improve the working of the international financial markets.*

This requirement equally concerns data on the macro-economic situation of developing countries in terms of short-term currency commitments or exchange reserves and also information relating to financial intermediaries and the private sector. It is an essential condition to ensure better practices. Various types of international Institutions should contribute to attaining this goal including the IMF on a macro-economic level, especially within the framework of *The Code of Good Banking Practices in the Area of Monetary and Financial Transparency* and of the reports drawn up after consultations on Article IV, the Basel Committee for the banks, the IOSC[5] for the stock markets and the IAIS[6] for the insurance companies, all of whom must strive to reinforce the rules for the centralization and disclosure of information in accordance with harmonized accounting principles, under the aegis of the IASC.[7]

(2) *While reaffirming, in fine, the superiority of the liberalization of the money markets, in order to optimize the international allocation of savings, the financing of growth and the creation of jobs, some twisting of the rules and some temporary control measures are considered as legitimate for developing countries given the dysfunctions observed on the markets in recent years.*

This principle chiefly concerns the preventive measures aimed at reducing the excessive influx of capital similar to those adopted in Chile recently. On the other hand, controlling the outflow of capital is considered counterproductive and should be used only in exceptional circumstances. At the same time, in order to limit the incentives for the short-term capital inflows and the excessive concentration of liquidity and exchange risks, governments should reduce the extent of guarantees provided on the domestic market for this type of external commitment, and contribute to the development of the domestic bonds markets in order to encourage, if necessary, long term debt policies in national currencies.

(3) *It is not a question of reconstructing a new monetary and financial system, but rather of introducing in a practical way a series of incentives, codes of conduct or standards that must be respected, in order to ensure better practices among the countries in the areas of international cooperation and exchange regimes and above all among investors and financial intermediaries operating throughout the world.*

The strengthening of international consultations, while remaining informal, must be extended to developing countries relying on the *IMF Interim Committee* which was granted permanent status after being transformed into the *International Monetary and Financial Committee.*[8] Even if one cannot say that one particular exchange regime is better than another, monetary stability and the sustainability of peg systems require cautious budgetary policies and, above all, the limitation of short-term external indebtness. In this sense, external financing on a large scale could not lastingly sustain an excessively rigid exchange rate.

However, it is mainly concerning the private sector that the need for stricter rules is expressed. The need to reinforce financial regulations is linked to international creditors underestimating the risks involved, especially in periods of so-called euphoria on the markets. According to the G-7 declaration, such shortcomings are not only the result of inadequate information but also of adverse incentives leading to excessive risk-taking. Hence there is the need to reinforce supervisory, surveillance and insurance regulation measures in order to reduce this kind of exposure. This led to the approval of the proposals of the Basel Committee in January 1999 regarding the evaluation of credit risk and the limitation of banking commitments granted to highly leveraged financial institutions. If it is necessary to define codes of good conduct especially for financial conglomerates, banks have their own specific concerns which include enforcing capital adequacy standards and evaluating more accurately and controlling the counterpart risk and foreign exchange position. This brings us back to the first principle since the control of better practices requires genuine progress in the exchange of information between national supervisors or between different professional organizations such as the IOSC and the IAIS, and even further the widening of the field of application, in particular in tax havens which can also be considered as prudential havens.

(4) *Contrary to what the supporters of the efficiency of the financial markets claimed, the probability of the outbreak of international financial crises is not all that low. Such crises must of course be forewarned but above all one must be ready to deal with them by planning rules of intervention which will ensure a more evenly balanced sharing of responsibilities between the creditor nations and the debtor nations, and by the contribution of the private sector.*

If the application of the previous three principles should make the prevention of crises, *ex ante*, more likely, it is nevertheless necessary to prepare for the management of international currency crises in order to limit the risk of contagion. This supposes greater international cooperation in order to provide concerted solutions, but also greater involvement on the part of private investors. The IMF's new line of conditional credit meets this objective but private lines of conditional credit should also be added in order to guard against the liquidity risks. If the outcome of the crises should not reduce the obligation of debtors to reimburse all commitments, it is at the same time vital that creditors shoulder the consequences of the risks they accepted, without any guarantee, *ex ante*, of the automatic intervention of the official sector. In the event of a crisis, the temporary reduction of net reimbursements can be envisaged, but no particular category of creditor should be privileged, and especially the bond holders should not benefit from any kind of precedence over bank claims. In a more general way, the international community should acquire a wide range of measures for intervening and sources for financing crises by directly involving the private sector even before the intervention of the international financial Institutions.

A close examination of the theoretical foundations implicitly underlying the G-7's position reveals a clear shift in the official doctrine which until now was favorable to the liberalization of capital movements. Can one see here, *post mortem*, the revenge of Keynes who spoke out clearly in favour of stricter rules for international markets, most notably at the Bretton Woods Conference?

THE THEORETICAL FOUNDATIONS OF THE INTERNATIONAL FINANCIAL ARCHITECTURE PROJECT: THE REVENGE OF KEYNES?

It goes without saying that a common declaration of the Finance Ministers of the G-7 cannot refer to a theoretical basis in order to justify its proposals. One can, however, make out a series of implicit foundations which underlie the options that have been chosen and which reply, implicitly, on a Keynesian reading of the sources of international financial instability. But it is by no means sure that the measures proposed by the G-7 take this reading into account.

To what extent, therefore, is it legitimate to refer to Keynes' revenge concerning the architecture project? Certainly not in the sense of a return to the precise terms of a *Clearing Union* as envisaged in the Keynes Plan written in 1941. It is rather in terms of the principles of international monetary and financial governance that a link with Keynes can be asserted.

Questioning the omniscience of international investors

In opposition to the text of the G-7, one no longer finds errors, at first, in macro-economic policy at the source of financial instability. This does not mean there are no such errors in the context of crises. But above all it is the irrational behaviour of private traders, under the influence of the herding behaviour and subject to changes in opinion, that is held responsible. The Finances Ministers of the G-7 now recognize that the markets, according to Alan Greenspan's expression, can be subject to irrational movements of exuberance or, on the contrary, suspicion. While underlining the need for the transparency and the quality of information, the G-7 declaration calls into question the omniscience of investors in the assessment of individual risks or the international allocation of assets. One can easily see the trace of the principles of the imperfect nature of information or of adverse selection as popularized by the neo-Keynesians. From this point of view, the implicit analysis of financial crises in terms of contagion, multiple equilibria and self-fulfilling prophecies takes us once again back to Keynes. In opposition to the individual investor optimizing his portfolio is the interaction of various traders possessing limited information and subject to mimetic effects. Against economic principles recognized by everyone and subject to measurable disruptions are set complex economic processes marked by discontinuity and uncertain outcomes. To the general equilibrium guaranteeing the efficiency of global finance are opposed the multiple equilibria and the possibility of divergent, chaotic or even explosive processes. When the instability of the markets is no longer necessarily a response to basic shocks but to changes in the prevailing opinion, and when instability spreads from one market place to another with no real discernment, all the players involved are weakened even by a local shock. These anomalies throw into question the capacity of the markets to allocate funds efficiently and to manage individual risks.

Here is Keynes as he wrote in his *General Theory*, first with a distinction between investors and speculators, the latter concerned only with 'forecasting changes in the conventional basis of valuation a short time ahead of the general public' (Keynes, *General Theory*, 1936: 170); but also with the importance given to the state of confidence: in other words, 'on how highly we rate the likelihood of our best forecast turning out quite wrong' (ibid., p. 164), which is at the origin of sudden changes in opinion. Keynes also alluded to changes in climate or context which can provoke 'waves of irrational psychology' (ibid., p. 169) whenever there prevails not a prediction based on reason, which today would be called rational, but rather 'a conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield' (ibid., p. 164).

The early Keynes, the one who wrote the *Tract on Monetary Reform*, was not so pessimistic. There the exchange rate depended on three basic principles: 'the internal price level, the volume of trade and the ability to borrow on foreign markets' (Keynes, *Collected Writings*, Vol. 4, p. 92), and the speculators had a stabilizing role, 'speculators, indeed, by anticipating the movements tend to make them occur a little earlier than they would occur otherwise, but by thus spreading the pressure more evenly through the year their influence is to diminish the absolute amount of the fluctuation' (ibid.).

However, Keynes soon changed his opinion. In his *Treatise on Money*, he insists less on speculation as such than on the drawbacks that result from dependence on foreign investments: 'a mere change in the demand schedule of borrowers abroad, he wrote, is capable, without any change in the monetary situation proper, of setting up a disequilibrium in the existing level of money income at home' (Keynes, *Collected Writings*, Vol. 5, p. 311). Of course, the consequences of this state of affairs are more serious in a fixed exchange rate system, like that of the gold standard Great Britain had adopted at the time when Keynes was writing his *Treatise*. In this case, in a free trade situation, the adjustment can rest only on two instruments: the variation in gold reserves, which are not unlimited, or a rise in interest rates. The latter is all the more worrying as a country's salaries and exports are more rigid, foreign capital less dependant and national investments more elastic to interest rates changes. Thus, 'the transition from one position of internal equilibrium to another required by the necessity for preserving external equilibrium may be difficult, dilatory and painful' (ibid., p. 314).

The Keynes Plan, coming after the *General Theory*, reveals the final state of the author's position regarding capital movements. Written by Keynes himself and published in 1943, it sets out the official position of the British government in the negotiations with the Americans about the post-war reconstruction of the international monetary system. This system, which resulted from the Bretton Woods Conference, is positively closer to the American proposal as defended by White, to set up an international stabilization Fund, than to that of Keynes which consisted, notably, in creating a supranational bank and currency. However, the functioning of the IMF and its subsequent evolution in the 60s and 70s showed that it was not so far removed from the position defended by Keynes as one could imagine in 1945.

The Keynes Plan contains a vigorous denouncement of the risks that are run by what he calls 'fugitive funds or floating funds: There is no country which can, in future, safely allow the flight of funds for political reasons or to evade taxation or in anticipation of the owner turning refugee. Equally there is no country that can safely receive fugitive funds which cannot safely be used for fixed investment and might turn into a surplus country against its will and contrary to the real facts' (*Collected Writings*, Vol. 25, p. 130).

The possibility henceforth envisaged by the G-7 to introduce measures which would slow down international capital movements was explicitly taken into account in the Keynes Plan. Keynes reckoned on a permanent control of capital movements being maintained after the war. He believed that in order to be effective, bearing in mind that the goal was not to forbid all movements of capital but only *floating funds*, such a control required the surveillance of all international transactions by both the country issuing and the country receiving the funds. On the contrary, *compensatory financial flows* for the movements of goods and capital movements corresponding to *genuine new investment for developing the world's resources* were to be encouraged.

Today, the G-7 is also expressing a marked concern for the problems of liquidity by proposing to limit the incentives – in fact the guarantees – for capital inflows or for short-term bank commitments. The same is true regarding crisis management and the need to curb early on the spread of the risk of liquidity. This is to recognize with Keynes that the basis of international financial markets is not only to ensure optimal allocation of assets but also to regulate the preference for liquidity which is the *Achilles' heel* of finance. It is in this sense that international financial stability has something in common with a public good as a bearer of externalities which justifies the implementation of an international system of financial governance. Such a system can take various forms: inducing better practices; introducing certain controls on the capital flows; strengthening and extending prudential standards and regulations in the face of the excessive risk-taking of certain traders; and officializing the function of international lender of last resort by mobilizing additional credit lines from the private sector, and so on.

If one thus accepts the necessity of a regulatory or insurance framework, or even the hypothesis of the control of short-term capital flows into emerging countries, the Finance Ministers do not for all that settle the question as to whether it is just a pause, a transition phase which will lead to stronger domestic financial systems before returning to the necessary principle of the liberalization of the transfer of savings or, on the contrary, a perennial option which is a response to the endogenous imperfections of the international financial markets. In this last case, this would mean, as Bhagwati for example maintains, that there is not just one single principle which guarantees global welfare, and, therefore, free trade should be associated with a controlled exchange in the area of financial assets.[9]

A more balanced share of adjustment constraints between debtor and creditor countries

The goal of strengthening international consultations which now involve emerging countries and, above all, the desire to share the responsibilities more equally between the creditor and the debtor nations, remind us once again of Keynes' position regarding the necessary symmetry of adjustments. Thus countries which were excessively in surplus were subject to negative interest rates on their assets in *bancors* and were supposed to practice an expansionist monetary policy or reevaluate their exchange rate. Accordingly, Keynes wanted to extend the principle of domestic banking systems to the international level: a hierarchically organized system with a central world bank – the *Clearing Union* – at its head. This bank would issue the international credit currency, the *bancor,* which would circulate among the national central banks. With the *bancors* circulating only by means of transfer between the accounts of the central banks at the *Clearing Union,* the latter would not run the risk of insolvency. The maximum amount of overdraft or *quota* of each country would be fixed according to its part in world trade. More precisely, Keynes envisaged the initial *quota* as being equal to the average amount of the country's trade (imports plus exports) during the three years immediately preceding the war.

With every country being able to increase the debit side of its *bancor* account by one quarter every year over a period of three consecutive years, the leverage effect resulting from the introduction of the international currency would have been considerable. A country which continued to export after the war as it had done previously would have been able to import three-quarters more than before the war, after three years, at very low cost, since the debtor countries would have had to pay annual interest of 1 percent on the average balance of their account up to half the quota, and then 2 percent on the rest.

However, Keynes did not wish to encourage the appearance of a structural imbalance of payments, especially for high amounts. First, in the course of a year a country was not to increase its debit account with the *Clearing Union* by more than a quarter of its quota without the authorization of the *Clearing Union,* but it could devaluate its currency in relation to the *bancor* by up to 5 percent if this was considered necessary. Whenever the overdraft went above 50 percent of the quota, the *Clearing Union* could impose measures to restore the equilibrium by devaluating the currency but also by setting up or reinforcing exchange controls, or even reimbursing in gold the part of the deficit corresponding to the amount over and above the authorized overdraft. Finally, when the debit account and not just its increase went beyond 75 percent of the quota, even stricter measures could be enforced including declaring a default on the reimbursement and forbidding further withdrawals.

Such measures could only slow down the growth in the imbalance. They could not prevent the deficits reaching tendentially 75 percent of the quota for a certain number of countries representing about half of all world trade. At this point, one of the most original measures of the Keynes Plan came into play, the goal of which was to oblige countries with a trade surplus to reduce a surplus that was too high. First, creditor countries were subject to negative interest on their assets in *bancors,* according to the same conditions, *mutatis mutandis,* as the countries with a trade surplus: 1 percent beyond a quarter of the quota, 2 percent beyond a half. Above all, a country whose credit balance went beyond

50 percent of its quota, over a period of one year, had to discuss with the *Clearing Union* what measures to take in order to restore its balance of payments equilibrium. These included *appropriate measures to increase credit and domestic demand, re-evaluation of the currency or an increase in salaries, the reduction of customs duties and quantitative import restrictions, loans to late developing countries.* In the event of disagreement between the *Clearing Union* and the country with a surplus, the latter would, however, still have the last word.

Without taking up the measures of the Keynes Plan, the articles of the IMF partially confirmed Keynes' idea of the symmetry of adjustments. During the negotiations which preceded Bretton Woods, faced with the reticence of the Americans who feared they would have to finance world trade to a greater degree than they were willing to, the British negotiators managed to convince them to accept the *apportionment of scarce currencies* which constitutes article VII-3 of the statutes. This clause allows member countries to restrict their current transactions with a country which has a structural surplus and whose currency, consequently, has been declared as *scarce* by the IMF because it has disappeared from its reserves. But the rare currency clause was never enforced.

One must add another direct link with Keynes regarding the dangers of a truly fixed exchange rate. With regard to developing countries, the idea that external financing on a large scale could not lastingly sustain an excessively rigid exchange rate and, above all, that a policy of prohibitive interest rates is not the appropriate solution for a debtor nation that is subject to a speculative attack, contrary to the policies imposed by the IMF at the very beginning of the Asian crisis, brings us back, once again, to Keynes. In a speech given in May 1944 to the House of Lords to defend the compromise which had just been drawn up between White and himself, he affirmed the following:

> We are determined that, in future, the external value of sterling shall conform to its internal value as set by our own domestic policies, and not the other way round. Secondly, we intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements of flights of hot money. Thirdly, whilst we intend to prevent inflation at home, we will not accept deflation at the dictate of influences from outside.
>
> (Keynes, *Collected Writings*, Vol.26, p.16).

The question of international financial institutions

All the measures envisaged by the Finance Ministers of the Group of Seven evade the question of the institutional forms and the delegation of responsibilities which would allow them to be implemented. It is, however, difficult to see how the international financial system could be consolidated without an institutional framework specifying both the practical functions and the competences to be respected. The question therefore arises of the organization of the international financial institutions whose task it is to manage financial and monetary stability which is a public good. Keynes had already anticipated this question.

In his *Treatise on Money* and during the run up to the Bretton Woods Conference, Keynes had underlined several principles in relation to this matter, first by expressing his mistrust of overly independent international organizations that are subject to administrative red tape and a very clear preference for what would today be called the networking of national institutions. Second, he underlined his preference for the responsibility in international monetary and financial matters being entrusted to central banks rather than to government representatives. In the *Treatise on Money*, Keynes deals with the question of an adjustment to the gold standard in order to meet the needs of the economy better. He proposes two models. First he describes one as *minimal*, changing to a gold exchange standard and creating a *Central Banks Committee*, chiefly responsible for modifying the reserves requirements of the currencies involved so as to avoid a shortage of currency and its deflationary consequences. But he preferred the maximal model which implied the creation of a supranational currency and bank. The new currency could be converted into gold at a fixed rate but it would rather take the place of the precious metal in most international transactions. Above all, it could be created by the supranational bank in the form of *discount credits* granted to the central banks of the countries that would be member nations of the system. All this was to allow the attainment of two related objectives: to stabilize the purchasing power of the supranational currency and therefore of gold, with reference to an index for the price of basic products traded at an international level, and, consequently, to prevent the appearance of any foreign inflationary or deflationary process.

As for the means, he envisaged they combine centralized action and coordination of the central bank:

> Its methods of attaining these ends would be partly by means of its bank rate, its discount quota and its open-market policy, but largely by consultation and joint action with and between its adherent central banks who would be expected to discuss their own credit policies at monthly meetings of the board of the supranational bank and to act, so far as possible, on lines jointly agreed.
>
> (*Treatise*, Vol. 2, p. 360)

The *Clearing Union* project followed essentially the system as described here, namely a network of central banks. As a matter of fact, when the

IMF was created, Keynes fought to impose this model. Apart from the choice of location for the headquarters (Keynes preferred New York to Washington as it is the most important financial market place in the world), the keenest debate was over who should govern the IMF. Keynes wanted the responsibility for operating the IMF to be entrusted to a body of international civil servants which would be under the authority of a part-time executive Council comprised of members who would keep their functions in their own national central banks. However, in March 1946, at the Savannah Conference devoted to the implementation of the Bretton Woods Agreement, Keynes found himself face to face with an American delegation determined to impose another mode of organization, in which the power would be mainly in the hands of full-time executive directors who would continue to be representatives of their respective governments. It is this organization that was adopted at Savannah, and Keynes, thinking afterwards about what the real intentions of the Americans could have been, came to the conclusion that they wanted to politicize the decision-making bodies of the two Bretton Woods institutions in order to have greater control over the process of economic reconstruction of the free world.

This debate over the institutions responsible for ensuring international financial stability has reappeared concerning the new architecture. How would Keynes have contributed to such a debate? He would probably have underlined the fact that the primary functions of the financial institutions are to encourage the development of business transactions and to ensure liquidity and a climate of confidence on the markets, without causing major damage to the system. When these two functions, which are indissolubly linked, are compromised, the question of the efficiency of the allocation of resources and that of the transparency of information take on a distinctly secondary nature. This is what justifies, on the domestic level, the irreplaceable role of the central banks in the management of the systems of payment and the exercise of monetary policy. In this sense, it is certainly to the central banks rather than to government representatives or the IMF that Keynes would have entrusted the responsibility of managing international financial crises, and therefore the function of an international lender of last resort. It is doubtful, however, whether governments are ready to give up such an eminently political prerogative to increasingly independent central banks.

The exercise which consists of looking for the Keynesian origins of the international financial architecture project, cannot be taken too far if only because of the profound upheavals that have shaken the world economy over the past 50 years. The monetary and financial systems have greatly evolved with share-ownership and deregulation. The globalization of international financial markets has replaced the compartmentalization of domestic markets and international capital movements are, according to the terminology coined by Meade, no longer compensatory flows. These transfers of savings have henceforth acquired real autonomy in relation to the need to finance the disequilibria in current accounts. At the same time, the size of these capital movements is such today that it gives them considerable destabilizing power, especially in the developing countries of Asia or Latin America. Even if the world economy has changed considerably since the 1940s, all these factors would no doubt have reinforced Keynes' anxiety in front of the power of the markets and the world economy. In this sense, Keynes' analysis of the sources of financial instability remains up to date.

This analysis of Keynes' position regarding international financial governance shows clearly that several of the guiding principles in the new architecture project are in keeping with Keynes' ideas: a mistrust of international investors and the necessity to subject them to certain standards of behaviour; the possibility of restricting capital movements, limiting inflows, but not forbidding outflows, even in a crisis situation; a more equal sharing of responsibilities between debtors and creditors, especially in the management of liquidity crises; and the need for greater international cooperation by entrusting the functions of financial governance to international institutions.

But the question of the reform of the architecture of the global financial system could not be reduced simply to a set of principles. The principles had to be transformed into institutions and rules. The political dimension therefore interfered with the economic requirements, and the new architecture is thus something of a compromise in which various different principles can be seen.

AN AMBIGUOUS AND UNFINISHED COMPROMISE

The new financial architecture does not only concern the theoretical principles or the financial techniques by means of which international financial instability – a negative outside force – can be controlled. There are also political issues at stake which affect the responsibilities assigned to markets and governments. Hence there is a need to round off the analysis of the new international financial architecture from the angle of political economy, thus allowing us to point out the rules of the game that are involved.

Substantive rules vs procedural rules

The theoreticians of international political economy deal with questions of economic governance and, therefore, modes of coordination which can be discretionary or can result from the application of more imperative rules, which permit the management of disagreements and the resolution of conflicts at the international level. This kind of approach, although at first limited to relations between countries, under the influence of, notably, Strange (1994), now extends to the markets and characterizes various modes of governance based on the notion of the international regime. According to the traditional definition of Krasner (1983), an international regime covers all the rules, standards and procedures which influence and ensure the cohesion of the decisions of the international players. Consequently, if we set aside the discretionary regulations that are subject to the hegemonic action of one of the leading countries or of a supranational institution, the theoreticians of international regimes make a distinction between two types of rules which govern the relations between states or even between states and markets (Kahler, 1995). On the one hand, *substantive rules* define precisely the standards of behaviour imposed by participation in the international game, and on the other, *procedural rules* lay down guiding principles or incentives, the application of which is not imperative but rather encouraged, and codes of good conduct which are standards of behaviour considered desirable and in the interest of everyone concerned.

If this mode of interpretation is applied to the problems of international monetary and financial governance, it appears that the official architecture project rests upon procedural rules and the *list* outlining the functions and the different areas of responsibility of international financial institutions and governments has not been redefined.

Indeed, the project to consolidate the architecture of the global financial system rests, as we have seen, upon a series of practical measures likely to reinforce the resilience of the financial markets. But the new architecture respects absolutely national sovereignty and prerogatives, as much for governments and central banks as for private investors. This *pragmatic incrementalism*, as coined by Bryant (1999), would be an answer to the concern over political realism and would justify the option of codes of good practice. It may, however, be accompanied by greater harmonization of the international financial markets, either by creating more uniform standards of behaviour in the area of insurance for example, or by setting up coordinated networks which would give greater efficiency to the existing institutions in the event of a crisis. The recent creation of the Financial Stability Forum illustrates this option, as does the informal mobilization of numerous professional organizations in the area of international finance (IOSC, IAIS, IASC . . .).

Qualified as a *middle way* by King (1999), this is a minimal strategy which avoids any heavy institutional innovation which might run up against political obstacles and which is based on a series of specific amendments concerning transparency, the circulation of information, macro-prudential supervision, and lines of credit that can be easily mobilized. It can even be accompanied by collective-action clauses in emerging bond markets or temporary control of capital movements, without touching the architecture as a whole. Keynes would certainly not have subscribed to such an option because it is more a question of consolidating rather than reforming the international financial architecture. The question is to know if this policy of incentives and steps forward in procedure is enough to face up to the challenges raised by the systemic risk.

At the same time, the theoreticians of international political economy underline the importance of the *cognitive foundations* of international regimes (Cohen, 2001), namely the fundamental principles which guarantee their cohesion and thus their stability. From this point of view, if the international financial architecture as defined by the G-7 and implemented by the IMF seems to mark a shift in relation to the Washington consensus, it is not without ambiguity and cannot be traced back entirely to Keynes.

A neo-liberal or neo-Keynesian conception of international finance?

At the time of the outbreak of the Asian crisis, the IMF Interim Committee on 21 September 1997 approved an amendment to the IMF's articles, which specified that the liberalization of international capital movements constituted an essential element of an efficient monetary system in the age of globalization,[10] and consequently entrusted the IMF with a new objective – the liberalization of the capital account placed under its responsibility and supervision. Priorities have changed considerably since then, but this new principle has not really been abandoned and this reveals the constitutive ambiguity of the new architecture as defined by the G-7.

It is, in fact, a question of preserving the international mobility of capital while furthermore recognizing the need for an institutional framework which can correct the imperfections inherent in financial markets, by reconciling in a way Fama and Stiglitz . . . If we envisage there being a control on the short-term capital flows into developing countries, the Finance Ministers of the G-7 and the US Treasury seem to see in this a pause during a transition phase leading to stronger domestic financial systems, before returning to the principle of the liberalization of capital movements.

In this sense, the new international architecture is much closer to a neo-liberal compromise than to a neo-Keynesian institutional framework: the coordination of the transfer of savings is a matter expressly for international markets even if state governance remains necessary, whether it is a question of prescribing standards which play a dissuasive role in the face of risk, or of managing, in a discretionary manner, situations of *stress*. This constitutive ambiguity explains the recourse to procedural rules for want of a political consensus allowing the reconstruction of a new *embedded liberalism* (Ruggie, 1982) of global finance, which would require the redefining of powers and the calling into question of the leadership of the US, particularly within the IMF itself (Aglietta et Moatti, 2000). The international financial architecture as conceived by the G-7 in Cologne thus constitutes a practical response to the new triangles of incompatibility caused by financial globalization,[11] from the moment that global federalism, either of financial standards or of international Institutions, is not on the agenda.

The increase of resources that can be mobilized immediately by the IMF has not been accompanied by a reform of procedures that would really permit acceleration of their possible use and to respond to the deficit of democracy as felt by developing countries. Over and above the declared principles, the involvement of the private sector in the management of crises and the question of the selectivity of financial claims in the event of a crisis, leads to legal difficulties that are not easy to overcome. As regards the transparency of information, it alone cannot eliminate the multiple equilibria and the herding behaviour. There are many variables among fundamentals, both macro-economic and macro-prudential, and they are organized hierarchically in very different ways according to the various theoretical principles used by the investors in their forecasts. Our knowledge of the thresholds above which an overall macro-economic configuration is considered sustainable or not by investors is very imprecise, and it is always difficult to measure the misalignment in the real exchange rates which make a speculative attack inevitable. This means that within the information whose transparency we wish to improve there is, it is true, a set of fundamentals, but also their arrangement, that is to say, the models of the world which, in terms of determining the prices of assets, are far from being established. Perfect transparency will never reduce uncertainty about the future and the subjective evaluation of risks. Keynes taught us this, but the Finances Ministers of the G-7 seem to have forgotten it.

There remains the question of the liberalization of international capital movements in developing countries. The reversibility of the capital flows is at the heart of financial weaknesses and it is dealt with in ambiguous fashion, as we have seen, in the new architecture project. Regarding this point, we would do well to remember one of the least outmoded of Keynes' ideas: the basis of finance is not only to guarantee the optimal allocation of assets but also to regulate liquidity which is the *Achilles' heel* of finance. For that, one cannot fully rely on markets and international investors.

CONCLUSION

The exercise which consists in looking for the Keynesian origins of the international financial architecture project leads us to a mixed appraisal. In the 1940s, Keynes had formulated most of the principles upon which the architecture should repose, particularly by underlining the need to limit or to control the very short-term capital flows. But such an option, marking the revenge of Keynes and his followers over the supporters of efficiency and the unbridled liberalization of the international financial markets, would require the appearance of a new world economic governance, bringing into play a new balance of power between America, Europe and the developing countries in Asia, but also between the markets, the central banks and the states. However, the main architects of the new international financial system, namely the US Treasury and the IMF, remain firmly opposed to such a solution.

There is no doubt that Rubin and the US Treasury have been at the heart of the options for the new architecture since they were deeply involved in the management of the crises among the developing countries starting in 1997 and especially at the beginning of 1998 when the plan for the new architecture was emerging.

On the one hand, faced with globalization, the US Treasury Secretary underlined the need to affirm the economic and financial leadership of the US in the interest of American citizens, which justified, before Congress, the refusal to adopt an isolationist or protectionist position, and the involvement of America in the management of the financial crises in Mexico, in south-east Asia and in Russia, given the importance of American exports to emerging countries (around 40 percent), much more than to Europe. It was, for Rubin, an affair of national security. In his famous speech delivered at Georgetown University on 21 January 1998, he began by saying:

> Today I would like to discuss the financial crisis in Asia; why the United States must protect its vital economic and national security interests by working to help restore financial stability and economic growth to that troubled region; and why acting promptly and effectively to do so protects the economic interests of every American.

On the other hand, he resolutely defended the need to modernize the architecture of financial markets, mainly in emerging economies where the financial crises began, by reinforcing the transparency, the regulation and the supervision of the markets. During the same speech at Georgetown University, he emphasized how much his experience on Wall Street had taught him that *the world economy needs an architecture that is as modern as the markets themselves*, along the lines of the Federal Reserve System and the Securities and Exchange Commission in the US, and therefore it needs a series of laws and rules to sustain the markets. According to Rubin, this covered four objectives: 'improving transparency and disclosure; strengthening the role of the international financial Institutions in helping to continue to deal with the challenges of today's global markets; developing the role of private sector in bearing an appropriate share of the burden in times of crisis; and strengthening the regulation of financial institutions in emerging economies'. These are the principles that the international community adopted shortly after. But then, as Rubin pointed out on 14 April 1998 when speaking at the Brookings Institution, the new architecture did not need an institutional innovation comparable to that which took place after 1945, since it was only a question of *consolidating and extending* to emerging countries the architecture of the financial systems of *modern* countries.

In these conditions, the new international financial architecture could not unfortunately mark the revenge of Keynes. It has been reduced to a compromise, more neo-liberal than neo-Keynesian, which seems ambiguous and unfinished. Meanwhile, in 2001, we are witnessing the outbreak of new financial crises in Argentina, in Turkey . . .

NOTES

1 The Group of 22 (referred to also as the 'Willard Group') was announced by President Clinton and the other leaders of APEC countries at their meeting in Vancouver in November 1997, when they agreed to organize a gathering of finance ministers and central bank governors to advance the reform of the architecture of the global financial system. The Group of 22 comprised finance ministers and central bank governors from the G-7 industrial countries and 15 other countries (Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, and Thailand). The G-22 commissioned three reports on strengthening the international financial architecture: *Report on the Working Group on Transparency and Accountability* (1998); *Report on the Working Group on Strengthening Financial Systems* (1998); *Report on the Working Group on International Financial Crises* (1998).

2 Cf. IMF (2000) *Progress in Strengthening the Architecture of the International Financial System*, Washington, 30 March; IMF (2001) *Reforming the International Financial Architecture*, Washington, 9 March; Goldstein, M. (2001) *An Evaluation of Proposals to Reform the International Financial Architecture*, NBER Conference on Management of Currency Crises, Monterey, California, March 28–31.

3 The Bank for International Settlements and the Basel Committee on Banking Supervision jointly created the Financial Stability Institute (FSI) to assist supervisors in improving and strengthening their financial systems. The FSI focuses on developing a common, in-depth understanding among supervisors of the Basel Core Principles for Effective Banking Supervision and on identifying supervisory measures that facilitate the successful implementation and enforcement of these principles across countries. FSI activities for the year 2001 will emphasize the following subjects identified by non-G10

supervisors as of greatest interest: The New Capital Accord; Risk management; Risk-focused supervision; Consolidated supervision.

4 It was J. Williamson who, in 1990, put forward the notion of the Washington consensus to account for the main options taken up by the IMF and the World Bank in the areas of development and structural adjustment: fiscal discipline, the privatization of public companies; the liberalization of interest rates, exchange rates, trade and foreign investment; the guarantee of property rights . . .

5 Officially, the member agencies currently assembled together in the International Organization of Securities Commissions (IOSC) have resolved, through its permanent structures to: cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offences.

6 The International Association of Insurance Supervisors (IAIS) is an organization comprised of national insurance regulators and supervisors from over 100 jurisdictions. Established in June 1994, the IAIS contributes officially to global financial stability through developing cooperation among members, setting international standards on insurance regulation, assisting members in complying with IAIS standards at national and international levels, coordinating work with other national and international financial institutions.

7 The International Accounting Standards Committee (IASC) is an independent, private sector body, formed in 1973 with the objective of harmonizing the accounting principles which are used by businesses and other organizations for financial reporting around the world.

8 The International Monetary and Financial Committee (IMFC) came into being on 30 September, 1999, when the IMF's Board of Governors adopted a Resolution approving a proposal of the Executive Board to transform the Interim Committee (known formally as the Interim Committee of the Board of Governors on the International Monetary System and established in October 1974) into the IMFC and strengthening its role as the advisory committee of the Board of Governors. Like the Interim Committee, the IMFC has the responsibility of advising, and reporting to, the Board of Governors on matters relating to the Board of Governors' functions in supervising the management and adaptation of the international monetary and financial system. The Committee, whose members are Governors of the IMF (generally ministers of finance or central bank governors), reflects the composition of the IMF's Executive Board: each member country that appoints, and each group that elects, an Executive Director, appoints a member of the Committee, which, like the Executive Board, has 24 members. A number of international institutions, including the World Bank, participate as observers in its meetings.

9 For Bhagwati, the principles of free trade and the free mobility of capital cannot be placed on the same level. There is indeed an 'asymmetry' between the two notions that cannot be assimilated. This can be explained by the fact that the mobility of capital, unlike the free trading of goods and services, is a source of shocks which are linked to destabilizing speculation and which are accompanied by deflationary policies. Besides, on an empirical level, one

does not observe, according to Bhagwati, a positive relation between the degree of liberalization of capital movements and economic growth. See also 'The Capital Myth', in Foreign Affairs, May–June 1998, cf. Bhagwati, Why Free Capital Mobility may be Hazardous to Your Health: Lessons from the Latest Financial Crisis, NBER Conference on Capital Controls, Cambridge, Mass., 7 November, 1998.

10 Cf., IMF (1997) 'Capital Liberalization Essential to An Efficient Monetary System', Interim Committee on the Liberalization of Capital Movements under an Amendment of the IMF's Articles, IMF Survey, 6 October.

11 For D. Rodrik (1999) a new international trilemma brings into play the international integration of economies, the preservation of Nation-States and the political conscience of economic agents (mass politics). For M. Aglietta (2000), the new triangle combines the national separation of banking supervision systems, the world capital market and an acceptable financial stability.

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