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Karl Kaiser

John J. Kirton
University of Toronto

Joseph P. Daniels
Marquette University, joseph.daniels@marquette.edu

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13 Challenges and Contributions to the Conventional Wisdom

KARL KAISER, JOHN J. KIRTON, AND JOSEPH P. DANIELS

Introduction

Reform of the international financial architecture is a dynamic and rapidly changing problem that by nature does not have a definitive answer. Hence, one would expect substantial disagreement on reform measures among the contributors herein. Remarkably, there is a strong consensus that emerges here. This consensus stands in stark contrast to the often "contradictory and mutually incompatible" (Eichengreen, 1999, p. 1) proposals offered elsewhere, primarily by economists and members of the policy community based in the United States.

This concluding chapter considers the views of some of the leading, U.S.-based authorities in the current debate on strengthening the international financial system, to identify their areas of overlap and divergence. The resulting, lengthy list of recommendations they provide is incrementalist in nature. It offers a baseline point of comparison for the evaluations assembled here. There is a general acceptance among these established authorities of the conventional wisdom on reforming the international financial architecture. The scholars and practitioners assembled in this volume, however, with their additional perspectives from Europe and Asia and North America beyond the United States, call for a bolder approach. They challenge the presumed effectiveness of many of the proposed reforms, offer new insights on encouraging stabilising behaviour of financial market participants, and add much-needed perspectives on the political process that is required for the development, acceptance, and monitoring of said reforms.

This chapter begins with a brief overview of the perspectives of some of the leading scholars on the international financial system. It then summarises the perspectives in the context of the core issue areas identified in the introduction to this text. Finally, it highlights the views offered in this volume, indicating the points of overlap and divergence with the conventional wisdom previously offered.

The Conventional Wisdom: A Brief Survey

Arguably the best-known contribution to the current debate is Barry Eichengreen's book, *Toward a New Financial Architecture: A Practical Post-Asia Agenda* (1999). A prolific writer on the history of the international monetary system, Eichengreen is well positioned to assemble and assess the views and proposals on reform that have been advanced by many prominent individuals and authorities.[1]

Eichengreen argues that most of the favoured proposals are incompatible with one another because different people view the problem of financial instability from divergent perspectives. His own proposals are advanced, in contrast, on the basis of five clear assumptions, as follows. First, financial liberalisation allows market to allocate capital in the most efficient manner and, therefore, has significant benefits. Secondly, and in contrast to others (such as Harold James 1999), integration of financial markets is irreversible. Thirdly, information asymmetries are pervasive in financial markets and, therefore, financial safety nets are needed in light of the instability generated by these asymmetries. Fourthly, bankruptcy codes are needed, as information and transactions costs prevent markets from promptly resolving financial crises. Finally, political considerations will influence economic reform.

Eichengreen chooses, as do the other established scholars reviewed here, to offer "recommendations [that] may seem unambitious … but have a chance of being implemented" (1999, p. 4). His approach is to offer proposals that are practical in light of the fact that though financial markets are ever-increasingly global, they continue to be regulated at the national level. His recommendations form the benchmark for this brief review and are summarised as follows.

Because of the problem of asymmetric information in financial markets, accounting and auditing standards should be advanced and adopted. The adoption of standards, and the monitoring of compliance will require a co-ordinated effort among international, national, and private sector bodies and should be addressed within the context of reforming the International Monetary Fund. In regard to improved information, Eichengreen specifically calls for:

Better information on businesses, banks, and sovereign nations, including:

- rigorous disclosure requirements;
- the use of internationally recognised auditing and accounting standards;

- improved corporate governance standards so that claimants can monitor and control; financial decisions;
- international monitoring of compliance and its public dissemination.

The pace of financial market liberalisation has been much more rapid than increases in supervision and regulation, particularly in emerging economies. What is needed, therefore, is:

Improved supervision and regulation of financial markets and market participants, such as:
- improved risk-management techniques of banks;
- improved regulation and supervision;
- limiting or taxing bank (principally foreign currency denominated) borrowing abroad, specifically Chilean-style capital-inflow taxes.

In regard to debt clauses, Eichengreen admits that no single country would pursue this alone as it might send an unfortunate signal to the markets. Hence, actions of this type can be accomplished only on a co-ordinated basis. His recommendation here is:

International Debt Restructuring, such as:
- adding majority voting and shareholding clauses to loan contracts;
- collective-representation clauses, including; provisions for a representative to coordinate creditors in the case of sovereign debt, and clauses providing that a minimum percentage of bondholders must agree for legal action to be taken;
- the creation of standing committees of creditors;
- IMF lending in arrears, when appropriate.

Eichengreen argues that the IMF must realise that it cannot solve all the problems of the international financial system by itself. The IMF must work with appropriate private sector organisations and international committees. In addition, the IMF should promote exchange rate flexibility as this will encourage agents to hedge foreign exchange exposures, reducing insolvency that results from unexpected exchange rate changes and Chilean-style capital controls. Hence, he calls for:

Reform of the IMF, to include:
- working with appropriate bodies to establish standards;

- monitoring member country compliance with these standards;
- becoming a pro-active coordinator of debt restructuring;
- enhancing its legitimacy through greater disclosure and transparency, forming a new consensus of appropriate macroeconomic policies in light of today's integrated financial markets, promoting Chilean-style capital controls, and encouraging flexible exchange rates.

Shortly after Eichengreen's analysis, Alan Blinder offered his own *Eight Steps to a New Financial Order* (1999). Both his theme and recommendations echo those of Eichengreen. Blinder maintains that financial instability cannot be eliminated, but sees the current situation of numerous and severe crises as unacceptable. Blinder also concurs that ostentatious proposals are a dead-end and that it is "Better to stick with more modest plans that require little or no institution-building. The world's poor cannot wait for grand edifices to be built" (1999, p. 53).

Five of the eight steps recommended by Blinder are in clear agreement with the proposals of Eichengreen: Flexible exchange rates, restricting excessive short-term borrowing in foreign currency, sound macroeconomic and financial policies (particularly improved bank supervision and accounting and auditing standards), reconsideration of IMF austerity programs in light of the modern international economy, and establishing procedures for debt settlement, including collective action clauses. In addition, Blinder argues for a proper sequencing of capital market liberalisation. This includes consideration of Chilean-style control on short-term capital inflows and tempering the IMF's encouragement of premature liberalisation. Blinder argues that the IMF pays too much attention to creditors and too little to the innocent bystanders in a financial crises. Hence, he argues that more resources should be devoted to protecting the social safety nets of nations from experiencing a financial meltdown. Finally, he argues for preventative funds, such as the IMF's Contingent Credit Line, to be available for countries that follow sound policies, in order to keep spectators at bay. He does not, however, go as far as to recommend regional agreements, though he does not address these explicitly or rule them out.

A third set of proposals has come from the Council on Foreign Relations, which in 1998 sponsored the Independent Task Force of the International Financial Architecture. Its report was authored by Morris Goldstein (Council on Foreign Relations 1999). The basic principles of the report is that the burden of reform is on the emerging economies and their creditors, but that participation is required by the industrialised economies as is reform and

redirection of the IMF and the World Bank. The Council offers seven recommendations. Five of these parallel those of Eichengreen (who was a member of the Task Force) and Blinder, though the context is slightly different.

The Task Force recommends that countries that practice "good housekeeping", (which includes sound macroeconomic policy, a strong and well-regulated banking system, compliance with international standards for disclosure, and avoidance of excessive short-term borrowing) be rewarded with more favourable IMF lending terms and lower regulatory capital requirements for banks lending to these countries. In addition, it proposes avoidance of excessive short-term capital flows with Chilean-style capital controls, flexible exchange rates, private sector burden sharing, and collective action clauses, and reform and refocusing of IMF and World Bank responsibilities.

The Task Force also suggests less IMF lending, specifically a return to normal lending limits of 100 to 300 percent of country quota. The belief here is that less lending will change private agents' expectations about future lending and reduce the moral hazard problem. Lending should focus on smoothing operations in currency markets, help finance bank restructuring, and provide for social safety nets, as advocated by Blinder. Finally, the Task Forces advocates greater political support of reform measures. As with Eichengreen, there is an admission that political considerations and will power will drive or stymie reform efforts. The Council urges greater involvement of the emerging economies in the process. They call on the Interim Committee, the Financial Stability Forum (FSF), and the presidents of the regional developments banks to convene a meeting of the finance ministers to set an agenda and time line.

A fourth major set of proposals comes from a symposium whose results were reported in the *Journal of Economic Perspectives* and summarised by Fredric Mishkin (1999). Though the symposium covered a great deal of territory, three issue areas found in all of the proposals above are treated in greater detail. These are the role of international institutions, banking stability, and capital controls. Mishkin and Rogoff (1999) concur with the Council on Foreign Relations that an international lender of last resort is needed, but argue it is not practical to envision one with "deep pockets". Mishkin's argument is based on the moral hazard problem that is created with such an institution while Rogoff focusses on the amount of resources that would be required. Rogoff reaches further, examining many other proposals for international institution formation and reformation, including the

establishment of a financial crisis manager and an international bankruptcy court. He concludes that none of these proposals are feasible at this time.

In this symposium, Caprio and Honohan (1999) deal with the problem of banking stability in emerging countries. They initially assert that capital requirements are not sufficient for dealing with banks in emerging nations, as in many of these nations financial liberalisation occurred faster than the establishment of adequate regulation and supervision of intermediaries. Hence, what is needed is better and increased supervision of intermediaries in these nations. As they see it, a principle problem that policymakers must grasp is that the solutions that work in industrialised economies may not work in emerging economies because of differences in market volatility and the institutional setting. Oppressive regulation, however, is not the solution. An environment that provides a framework of incentives that encourages diversification and balancing of loans and competition is one that enhance the efficiency and stability of these banking systems.

Sebastian Edwards' (1999) task is to consider the capital controls recommended in all of the proposals noted above. He argues that the evidence shows that controls on capital outflows are ineffective while the benefits of controls on the inflow of capital, such as those used by Chile, are overrated. Nonetheless, controls on short-term capital inflows may extend the maturity of debt and, therefore, be a useful *temporary stopgap* measure. Ultimately, what is needed is the obvious medley of prudent macroeconomic policies, banking regulation and supervision, and flexible exchange rates.

The Consensus of the Conventional Wisdom

The authors reviewed above agree that the worst of the Asian crisis is now past, but that similar financial failures are inevitable in the future, given the current environment. Liberalised financial markets will always be prone to seizing up. No reform effort, no matter how comprehensive it might be, can completely eliminate this aspect. Liberalised financial markets are certainly beneficial, as they direct capital to its most productive function. Yet when markets are liberalised prior to necessary microeconomic and macroeconomic reforms (such as proper monetary, fiscal, and exchange rate policies, and appropriate banking and domestic financial market regulation and supervision), large and sudden inflows and outflows of short-term capital can overwhelm an emerging nation's system of intermediaries, leading to a financial melt-down. It appears that this is precisely what happened in East Asia from 1997 onward.

Though financial markets are becoming more globally integrated, they remain regulated at the domestic level. For emerging nations that rely heavily on their domestic banking system for the allocation of capital, and that have less than sufficient competition, regulation and supervision, liberalisation has proved to be a risky process. A great deal needs to be done here. The industrialised nations need to set the example for the emerging nations through the approval and adoption of accounting, disclosure, and auditing standards. Much is now being done in generating such standards. The difficult task that lies ahead will be ensuring their acceptance and monitoring compliance with them. The G7, IMF, and the committees of national regulators must co-ordinate their efforts in this regard. They must further devise a system of incentives that encourages market participants and the governments of the emerging and developing nations to comply.

There is no question that informational asymmetries pervade financial markets and that this type of market failure is amplified in international transactions. Improvements in transparency and surveillance are important, but in and of themselves will not accomplish much. Rather, there is a need for more draconian measures such as capital controls on short-term inflows. This type of measure is offered with trepidation, but offered nonetheless. The purpose is to extend the average maturity of debt and reduce the reliance on bank borrowing from abroad.

Private sector involvement is certainly a common element of all the proposals above. Each collection has called for shareholder clauses on loans and collective-representation clauses on debt. These types of measure have the potential to reduce the quality of debt issued by sending the wrong type of message to market participants. As a result, no nation would unilaterally adopt these measures. A coordinated effort is required. The prospect of a co-ordinated effort, however, seems unlikely as long as the United States remains firm in its opposition to reform in this area.

The area that receives virtually no attention at all is the role of the G7 in the overall process. This is quite unfortunate as the G7, both at the leaders, and Finance Ministers level, represent the critical political force necessary for any reform to take place. While earlier G7 action may have proven disappointing in its foresight, timeliness, and content (Daniels 1999), as the Council on Foreign Relations Task Force rightly argues, greater political support of reform efforts is needed. The G7, and the extended fora of the G7, are essential in coordinating the activities of the various bodies at work on the formation of standards, the promulgation of such standards, and the encouragement of their adoption.

Challenges and Contributions to the Conventional Wisdom

The analyses offered in this volume contain a number of points of convergence with the views presented above. However on the whole they mount a challenge to the conventional wisdom by adding a more diverse and often bolder view on the origin of recent crises, the specific direction to be taken, and the political process that will steer the entire operation.

There is a consensus on the benefits of globalisation of financial markets that is driven home in the works of Rugman and Daniels. These authors also agree that short-term capital flows can be destabilising, whereas foreign direct investment is not. Rugman goes further on this issue by pointing out that the process of integration is in fact driven by foreign direct investment activities of multinational enterprises. The authors diverge from the conventional wisdom by shifting away from the focus on short-term flows, as capital controls on short-term inflows are, at best, second best policies. In addition to the obvious reforms needed in banking and financial market supervision and regulation, what is called for is a regional system of incentives that encourages long-term investment, as opposed to schemes that discourage short-term capital. Indeed, Rugman argues that the lack of such a strategy is a central explanation of the East Asian crisis.

There is also much agree on the proper role of the IMF. Giannini concurs that there is a role for a lender of last resort. He leads the debate in a new direction by arguing that the IMF is already heading away from being an *international* lender of last resort and toward becoming a lender of credibility. That is, the IMF can provide credibility to otherwise sound economies that have experienced a crisis by lending into arrears and by enabling them to access private capital courses. Von Furstenberg adds, building on Goodhart (1999), that borrowed money should not be used to defend exchange rate pegs. What von Furstenberg also brings to the debate is the realisation that most of the crisis countries have abandoned pegged regimes and the challenge now remains one of finding the appropriate regime. It appears that regional arrangements are inevitable with many national currencies disappearing in the process.

That reform of banking supervision and regulation is essential to successful financial market regulation is unarguable. Kiuchi, however, points out that a critical element missing in the debate over reform is how politicians

compound the problem by overriding banking officials and regulators. No reform, regardless of how well intentioned it might be, can be successful without proper political backing. There is a need, therefore, to develop alternatives to domestic banking systems that allow for direct financing. Hence, Kiuchi argues for the development of an Asian bond market which would replace some of the short-term bank borrowing abroad, and also extend the maturity of debt.

A lack of the type of transparency that is called for in the conventional wisdom had little to do with the outbreak of the East Asian crisis, as argued by von Furstenberg. Information asymmetries are an important element in such crises, but the measures currently envisioned will do little to prevent similar crises from occurring in the future. What von Furstenberg brings to the debate is the importance of *political* transparency. That is, being clear as to motives and to whom the benefits of reform will accrue, will do much to enhance the credibility of the reform process itself. Walter echoes this scepticism about the impact of transparency and argues that much more needs to be done in the way of bank capital requirements. Walter concurs with the conventional wisdom that a new mechanism is needed to allow bankruptcy and that the recapitalisation of failing financial institutions should be halted.

The Role of the G7

Among all the authors in this volume, there is a widespread consensus about the central role the G7 plays in responding to international financial crises, and strengthening the international financial system to reduce the massive economic, political and social costs which such crisis can exact upon so many. This consensus embraces the relevance and leadership role of the G7 in these issues, its relationship to the other bodies charged with their management, the effectiveness of its performance in crisis response and system/reconstruction, and where and how it should concentrate its efforts in the future.

The Relevance and Leadership Role of the G7

There is overwhelming agreement that the G7 and its leadership have been, and should be, central in the process of responding to international financial crises and constructing a new system to meet the needs of a now globalised world. Bayne shows how responding to crisis and reconstructing the international financial system in its various dimensions has recurrently been

the central tasks of the G7, and that it have been critical in solving differences that have persisted at lower levels, keeping up the pressure to ensure what members have agreed is properly carried out, and in explaining and justifying their actions to outside countries and the broader public. Kirton regards it, rather than the IMF or US alone, as playing the central part during the crisis of 1997-99. Daniels argues that the G7's performance in coordination and implementation will determine the ultimate success or failure of the effort to reform the international financial system.

Even those with more critical views admit its relevance. Kiuchi, amidst his sympathy for regional solutions, views the 7 as having an important leadership role in catalyzing needed action at an early stage, and in helping Asian nations develop guidelines to help them develop their financial systems. Wood sees the G7 as central to the global coordination of economic policies, even though he argues it has now become an "anachronism" given the rising weight of developing countries, shifts in trade competitiveness, and the new vulnerability among all nations brought by globalisation. Von Furstenberg admits the useful role the G7 played in endorsing IMF incubated codes and in strengthening the IMF's Interim Committee, even while recognising the limited relevance of such an emphasis. Walter suggests, in keeping with the American leadership model of international co-operation and G7 effectiveness (Putnam and Bayne 1987), that the G7 can play a key role in providing the United States with the junior partner it needs to work with, in a world of "Snow White and the Seven Dwarfs". Gianini approves of the G7-inspired informal ways devised to deal with the Asian crisis and Korea, and the G7's creation of the Financial Stability Forum. Only Rugman, with his emphasis on the role of foreign direct investment, multinational enterprise's regionalism and regional institutions, implicitly casts doubt in the relevance of the G7 itself in the broader scheme.

The G7's Relationship to the Other Financial Institutions

At the same time, there is an equally strong conviction that the G7 can act perform its needed role if it works in tandem with the established multilateral organisations regional bodies, in ways that incorporate more fully the work of outside countries and private sector forums. Bayne underscores the need to ground G7's decision in the formal constitutional and institutional structure of established international organisation such as the IMF if they are to be effective in the long run. Kirton shows, consistent with the model of democratic institutionalism for explaining G8 performance (Kirton and

Daniels 1999, Kokotsis and Daniels 1999), how the G7 needed the IMF, International Bank for Reconstruction and Development (IRBD), and regional development banks as a nest for catalysing co-operation and for securing resources to help stem crisis of 1997-9. For Daniels, it is the G7 that can help provide the badly needed clarification of the roles of the IMF and IBRD. Kiuchi calls for an enhancement of the IMF's authority to deal with capital account liberalisation. For von Furstenberg, and Walter the IMF and BIS were central in generating the standards to secure greater transparency, with the G7 endorsing their work, although the former sees the IMF as poorly positioned to engender the needed moves away from floating exchange rate regimes and into the world of regional monetary union. For Rugman, in contrast, multilateral and plurilateral bodies such as the Organisation for Economic Co-operation and Development (OECD) and General Agreement on Trade and Tariffs (GATT) and the World Trade Organisation (WTO) have failed to provide the needed rules for investment liberalisation, while regional bodies are busy generating results.

The need to involve outsiders in the work of the G7 is underscored by many of the analyses in this volume. Kiuchi points to the need for regional arrangements such as an Asian Monetary Fund (AMF) and regional policy co-ordination, or bilateral plans such as the New Miyazawa Initiative. Wood applauds the Cologne G7's decision to enlarge the FSF and give new responsibilities to the IMF's renamed International Finance and Monetary Committee, as the start of a much-needed process of greater inclusion. Kirton notes how the G7 broadened to include others through the FSF and G22 in devising the new system. Daniels echoes this plea to include large developing countries. Bayne, expanding on his earlier call (Bayne 1999) and noting the success of the process leading to the Cologne debt initiative, points to the importance, especially in the wake of the failed Seattle WTO meeting, of better communication with public and civil society actors.

The Effectiveness of G7 Action in Crisis Response and System Reconstruction

All the authors point further to the wisdom and effectiveness of G7 action in crisis response and system reform, although most also identify instances when G7 agreement and action was poorly conceived, insufficient, or badly executed. Bayne's review of the G7's four major efforts during its first 25 years reveals a variable record, ranging from a highly but not totally effective

response in 1975, through to a much delayed impact on middle income debt relief from 1982 onward, relief of debt of the poorest from 1988 onward, and crisis response and system reconstruction from 1994 to the present. Wood believes the Cologne communiqué makes a significant contribution to strengthening the international financial architecture, but gives the report a very cautious evaluation, and one that expresses skepticism about the ability of the G7 to implement it effectively in the absence of broader participation from the developing countries themselves. He further judges the G7 in general to be highly effective in macroeconomic co-ordination, but notes its *ad hoc*, cases by case approach to developing country debt relief in the 1980s left the system highly vulnerable to the crises of the 1990s. The highest marks come from Kirton, who concludes the G7 beat markets in South Korea, Brazil, and over private sector burden sharing, and successfully contained Asian and global financial crises, if through the provision of "just in time" "just enough" leadership. He concurs with Bayne that it was ultimately action by the G7 leaders themselves that was needed, and that the G7 leaders were much better at responding to crises than at foreseeing and preventing them.

The economists in this volume substantially agree with this portrait, although offer more harsh judgements about the market rationality of many of the particular decisions the G7 produces. Kiuchi suggests the G7 has been effective in its *de facto* task of surveillance and coordination of exchange rates. Daniels sees the G7 Finance minister's report to the leaders at the Cologne Summit as a comprehensive, high quality document that reflects well the work being done by the G7 and others since the Halifax Summit of 1995, and one that does an excellent task of framing the current situation. He does, however, note the G7 at Cologne provided little detail on private sector involvement in crisis prevention, and was not firm enough in its conclusions on exchange rate regimes. Walter, while implicitly approving the FSF, points to the need to address more basic and hitherto neglected issues. Von Furstenberg remains the most critical, declaring that its HIPC initiative is a debt trap, that its approach to transparency only helps those at the top of the hierarchy, that this approach will do very little to reduce the risk of financial crises occurring in the future, and that the G7 Report underplayed the role of exchange rate regimes in emerging economies in the overall architectural effort.

The G7's Focus for the Future

Finally, many authors in this volume have clear views as to how the G7

should proceed in the future. Bayne calls for a broadening and shift of attention, through the G7 correcting their neglect of the trade system as their first priority for Okinawa 2000. This involves resolve their internal differences on trade liberalisation, restoring the authority of the WTO, making their own policies and the WTO more responsive to the requirements of developing countries, especially small and poor ones, and getting the Millennium Round successfully launched. Wood argues with equal conviction that in the future G7 decision making will have to be more inclusive of the views of certain large developing countries, and that G7 countries should give technical assistance to LDC's to help them develop mechanisms to reduce systemic risk. Kiuchi suggests the G7 should provide leadership to secure a *de facto* target zone mechanism for exchange rates among the big three, give the IMF authority for capital account management, and look with favour on regional co-operation on macroeconomics policy and the development of Asian bond market.

It is Daniels who provided the boldest vision of the G7's required role in the future. He declares that the G7 must play the essential task of managing the many bodies at work in reforming the international financial architecture. To do so it must co-ordinate the overall process, serve as a driving force for the implementation of agreements, and act as the leading advocate of benefits of capital account liberalisation. It is thus clear that, despite the substantial steps forward made by the G7 at Cologne, their central role and formidable challenge in strengthening the international financial system to meet the needs of the new millennium will remain active in the years to come.

Note

1 Of course the literature on financial crises and reforms to the international financial architecture is substantial, as evident in the collective references to this text. We focus only a few of the most widely-distributed publications here so as to derive a concise summary. For an excellent symposium on the Tequila Crisis of 1994-95, we refer the reader to volume 23 of the *Journal of Banking and Finance* (1999).

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