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KEY ISSUES IN THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

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Objectives and areas of reform

1. This note examines briefly the issues in the reform of the international financial architecture raised by recurrent instability and crises in the international monetary and financial system, particularly the current global financial crisis triggered by extensive speculative lending and investment in the United States and elsewhere. It focuses on key areas of reform for:

- Preventing or reducing the likelihood of financial crises with global ramifications;
- Minimizing negative external spillovers from crisis response by governments;
- Improving international intervention in and resolution of crises in emerging markets.

2. There are basically three interdependent sources of international monetary and financial instability – that is, instability in global asset markets, international capital flows and exchange rates:

- Policies in systemically important countries, including some larger emerging markets;
- Problems inherent to an international reserves system based on a national currency, the dollar;
- Financial and currency markets.

3. International reform efforts for crisis prevention should address all three sources of instability. More specifically, consideration should be given to introducing new multilateral arrangements and mechanisms, or strengthening the existing ones, in order to secure:

- Effective multilateral discipline in macroeconomic and exchange rate policies with a view to securing stable exchange rates and payments conditions;
- Establishment of an international reserves system not based on a national currency;
- Effective regulation and supervision of international financial markets and capital flows.

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Multilateral policy discipline in money and finance

4. Adverse global spillovers from macroeconomic, exchange rate and financial policies in systemically important countries have proved more damaging than those from trade policies, but unlike the latter they are not subject to multilateral disciplines.

5. The IMF members have the same *de jure* obligations to maintain orderly exchange rates, macroeconomic and balance-of-payments conditions. But the Fund is unable to exert meaningful disciplines over the policies of its non-borrowing members. A key question is how to remove this asymmetry and make surveillance effective, even-handed and independent of IMF lending.

6. In carrying out its surveillance function, the Fund should recognize that macroeconomic, exchange rate and payments stability depends as much on combating inflation in asset markets (asset bubbles) as combating inflation in labour and product markets.

A stable international reserves system

7. An international reserves system based on a national currency is inherently unstable because availability of adequate reserves for the world economy as a whole depends in large part on the reserve currency country running growing current account deficits. Under current circumstances this problem is aggravated by three factors:

- Absence of effective multilateral discipline over exchange rate and macroeconomic policies of the United States; a discipline that the Bretton Woods System sought to establish through gold convertibility of the dollar at a fixed rate;
- Increased vulnerability of developing countries to boom-bust cycles in capital flows and gyrations in exchange rates as a result of their closer integration into the global financial system;
- Pro-cyclical behaviour of financial markets whereby funds tend to dry out when they are most needed. This, together with the absence of an international lender of last resort (ILOLR), compels developing countries to hold large stocks of dollar reserves at very high costs, estimated to be in the order of some $130 billion per annum.

8. A possible area of reform is to establish an ILOLR. However, this is neither feasible nor desirable. It would not address the question of global financial instability and may even aggravate it by encouraging imprudent lending and investment.

9. Consideration could be given to establishing a genuinely international reserves system based on the SDRs (Special Drawing Rights):

- One advantage of such an arrangement would be that unlike dollar reserves, holding SDRs does not entail costs; cost is incurred only when they are used;
- The Fund may be allowed to distribute SDRs to itself to make it available to its members. In principle access should be for current account (trade) financing; Amounts to be made available could be greater than those under existing IMF facilities. There should also be greater automaticity in access.

Regulation and supervision of international financial markets and capital flows

10. Even when monetary and fiscal policy discipline is secured and a relatively high degree of price stability attained, unbridled financial markets are capable of generating instability, with serious consequences for the real economy, notably jobs and incomes. The Anglo-American approach that financial markets regulate themselves has proved not only wrong but highly damaging.

11. After recurrent crises in emerging markets in the 1990s there was a proliferation of proposals to establish a system of multilateral governance for finance including a World Financial Authority, in the same way as the WTO in trade. Now the subprime crisis has created consensus over tighter regulation of financial markets and institutions. Several reasons are given why regulation should be international: that is, since financial instability has adverse global spillovers, national regulatory practices should be subject to multilateral disciplines; this would also reduce the influence of politicians on regulators and prevent regulatory arbitrage whereby business could run away from tightly to lightly regulated jurisdictions.

12. While these considerations are basically valid, they are not easy to put into practice. This is particularly true for a comprehensive and fully fledged global system based on:

- Binding multilateral agreements on a set of rules and regulations for commercial and investment banks, institutional investors (pension funds, equity funds, hedge funds, sovereign wealth funds etc.), rating agencies, bond and credit insurance companies;
- Commitment by governments to implement such rules and regulations through national regulators;
- A multilateral institution (secretariat) to oversee implementation and to impose sanctions for non-compliance.

13. Quite apart from the unsettled question of how best to regulate financial institutions and markets, it is unrealistic to expect systemically important countries to give up national policy autonomy to the extent required, particularly since for such an institution to have genuine clout, it should have a distribution of power markedly different from the existing multilateral financial institutions. It is notable that even the EU has not managed to establish a common regulatory system.

14. For developing countries, there is also the problem of one-size-fits-all. In all likelihood, uniform rules and regulations to be agreed would be shaped by institutional features and needs of the more advanced countries and these would not always be suitable for financially lesser developed countries. Although the latter may be given special and differential treatment, the record of multilateral arrangements in this area, notably in the WTO, is not very encouraging. Furthermore, on current thinking in the major advanced countries, a fully fledged multilateral regime is likely to impose provisions for greater capital account openness and market access in financial services in developing countries.

15. Alternatively a selective, rather than comprehensive approach could be pursued. For instance international supervisory bodies could be established for large transnational banks and credit rating agencies on the basis of agreed standard and rules. Again such a step would involve complex issues of sovereignty and power of international bodies vis-à-vis national regulators.

16. Still a less ambitious variant would be to extend the mandate and improve the governance of existing bodies such as the Financial Stability Forum, the BIS, Basle Committee on Banking Supervision, and the International Association of Insurance Supervisors. There are

also proposals to push the IMF in that direction. However, the Fund should remain, after appropriate reform and restructuring, as an institution to secure multilateral policy discipline and provide short-term payments support to meet temporary balance of payments difficulties, rather than getting into the management of the international financial system.

17. Several existing proposals for international approach to regulation of finance envisage a voluntary process of coordination among national regulators, supplemented by greater autonomy and independence to protect them from political influence. Whether or not this would address the problems laid bare by the subprime crisis and its global spillovers needs to be carefully assessed.

18. Developing countries need to elaborate an agenda for reform of the international financial markets, including modalities of reaching and implementing agreements on regulations, with a view to minimizing their vulnerability to external financial shocks. Such an agenda could contain the following elements:

- Regulations to reduce pro-cyclical behaviour of international lenders to developing countries;
- Regulation and supervision of all internationally active non-bank financial intermediaries;
- Regulation of international investors in emerging markets, notably highly-leveraged institutions, notably hedge funds, including reporting and disclosure requirements and restrictions regarding leverage and liquidity and investment strategies;
- Reform of credit rating agencies including elimination of conflict of interest, greater disclosure for their working methods, elimination of pro-cyclical rating and the general bias against developing country borrowers, accountability for the quality of their recommendations, and facilitation of entry of new agencies. Reform in this area should be designed to secure both a more objective rating of issues from developing countries, and a more reliable rating of securities issued in advanced economies and held in portfolios in developing countries;
- Rules designed to reduce or eliminate perverse incentives in financial firms (such as those related to executive pay) encouraging excessive risk taking and speculation;
- Introduction of a statutory framework to allow unilateral temporary debt standstills and capital controls in countries experiencing serious balance of payment problems and to provide protection against litigation by international creditors and investors;
- Introduction of arbitration for orderly and equitable restructuring and work-out of sovereign debt of developing countries to both private and official creditors.

Crisis intervention and resolution: national

19. Crisis response by national governments can have adverse global spillovers, the latest examples being the import restrictions and industrial subsidies in the United States' fiscal package and financial bail-out operations. Crises also provide humus to beggar-my-neighbour exchange rate policies. The inter-war experience shows that such policies could lead to the breakdown of the international trading and payments, rather than solving the crisis. Preventing such an outcome calls for strengthened multilateral surveillance.

20. Free riding/coordination problem: Overcoming a global financial crisis with strong deflationary impulses requires, *inter alia*, expansionary fiscal and monetary policies. There are no multilateral fora where such policies could be effectively coordinated. Rather, countries

are sometimes tempted to free ride, seeking to benefit from expansionary policies in their trading partners.

Crisis intervention and resolution: international

21. IMF interventions in previous emerging market crises were generally designed to bail-out international creditors and investors, to keep emerging markets current on their debt payments and to maintain an open capital account, rather than to provide support for imports, economic activity and employment. Such bail-out packages were often made conditional on the pursuit of pro-cyclical fiscal and monetary tightening, thereby deepening economic contraction.

22. This was increasingly seen as problematic by many countries, including in the industrial world, on grounds of moral hazard, unequal sharing of the burden of the crises between debtors and creditors and its impact on poverty. Certain initiatives were taken to reform the modalities of IMF intervention in emerging market crises, including new mechanisms to bail-in (involve) the private sectors and the terms and conditions of IMF lending. Nevertheless, with rapid recovery in emerging markets hit by the crises and opposition from financial markets and the United States government, these initiatives were abandoned.

23. Now with the crisis spreading globally, a number of emerging markets have had to seek IMF support. First signs suggest business as usual: pro-cyclical macroeconomic tightening and primacy given to maintaining capital account convertibility and avoiding default, rather than quick and strong recovery. Perhaps one of the first issues that the international community should address is the modalities of IMF intervention in emerging markets affected by the global financial crisis.

24. Attention may also be given to allow the SDRs to replace quotas and GAB and NAB as the source of funding for the IMF in order to reduce the excessive leverage of its creditors on the Fund's policies in such interventions.

25. Under present conditions it would be highly advisable to establish a global countercyclical facility to reduce the likelihood of the financial crisis pushing the world economy into a deep and prolonged recession – very much like the two oil facilities established in the 1970s in order to prevent oil price hikes from triggering a global recession. This should be funded by a reversible SDRs allocation, rather than borrowing from reserve-rich countries.