RESPONDING TO THE GLOBAL ECONOMIC CRISIS: THE CRUCIAL ISSUES

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The financial turmoil that erupted in the US in mid-2007 has become the worst financial crisis since the Great Depression and the worst recession since the Second World War. As the crisis deepens, its social costs have also been mounting. The crisis is global and systemic in character. It has shown, in particular, how dysfunctional the current international financial architecture is to manage today's global economy.

The political responses have been diverse and have included several domestic bank bailouts and stimulus packages in industrial and, at the international level, a series of initiatives launched by the G-20. The financial meltdown has been considered a serious threat, but the solutions have so far proved insufficient. In contrast, there has been a tendency to underestimate the intensity and likely duration of the crisis, as well as its systemic implications. This is reflected in the small size of many of the stimulus packages and the narrow agenda that has so far been the focus of international negotiations. This is a major mistake. The intensity of the financial meltdown of September 2008 and the severity of the recession and collapse of trade that followed surprised even experts. Although expectations have been scaled down, the timing and strength of the recovery is likely to give many new unpleasant surprises.

This document summarizes the crucial issues related to the origins and management of the current world economic crisis. The first two sections look at the roots and spread of the crisis. The next two analyze the areas where government actions have concentrated: the macroeconomic stimulus packages, financial bailouts and regulation. The last section considers broader reforms in the international economic architecture and associated institutional changes which have been excluded so far from negotiations.

1. The roots of the current crisis

The peculiarity of the current crisis is, of course, that it originated at the center of the world economy. The collapse of the market for asset-backed securities in the US in August 2007, including the market for subprime mortgages, can be taken as the start of the financial crisis. However, the European financial system has also been at the center of the turmoil. The first major bankruptcies took place in Britain (Northern Rock) and Germany (IKB) at the end of 2007. This reflects not only for the significant portfolio of US "toxic" securities held by European financial institutions, but also their own problems associated with the collapse of housing bubbles in several countries, higher reliance of

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European on capital markets vs. deposits, and the serious financial turmoil in the European periphery (Iceland and Central and Eastern Europe).

The roots of the crisis will continue to be debated for a long time. The major issue was undoubtedly the excessive confidence in the capacity of financial markets to self-regulate and self-correct in the face of disturbances. By now it is clear that the dominant economic paradigm provided a grossly inadequate lens to analyze reality. The regulatory deficit is now broadly recognized. This problem is most severe in industrial countries, which continued to deregulate while many emerging economies took steps to strengthen regulation after their own financial crises. Equally important is the insufficient supervision of financial institutions and, therefore, the incapacity of authorities to make effective those regulations that were in place. At the international level, for example, the Financial Stability Forum (FSF) was created by the G-7 in 1999 "to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, thus destabilizing the world economy". Similarly, after the Asian crisis, the IMF was given, together with the World Bank, enhanced responsibilities in the surveillance of financial stability. Despite their very useful technical work, the FSF and IMF patently failed in giving warning early on of serious problems to come, as did the regulators and supervisors in major industrial countries. More serious warnings came from different quarters, including the Bank of International Settlements and the United Nations.

Aside from the regulatory and supervisory deficit, and the failure of FSF, the IMF, and financial authorities in industrial countries to provide early warning signals, other factors contributed to the financial meltdown. Major failures in corporate governance and associated incentive schemes are now widely recognized as a major problem, particularly the excessive focus on short-term profits and shareholder value, and the tendency to remunerate top managers on the basis of short term returns. The expansionary monetary policy of the first half of the 2000s are also accepted as a major contributor to the crisis, though the interpretations differ among analysts (and are not necessarily incompatible). Some see it as simply a policy mistake that, through the attempt by financial institutions to increase their returns ("search for yield") in a low interest rate environment, led to very risky investments. Others see it as a reflection of the need to compensate for the weak aggregate demand generated by adverse trends in income distribution throughout the world. Access to credit was needed, according to this view, to compensate workers for the low earnings, at the cost of building up unsustainable household indebtedness.

Global imbalances also figure out prominently in the debate, with again contrasting views (in this case, incompatible ones). According to one interpretation, Asian and, particularly, Chinese "mercantilism" generated massive surpluses that increased the demand for US financial assets and kept interest rates –including long-term rates— low. The alternative interpretation emphasizes rather the fact that the 1997-8 Asian crisis made it clear that the world lacks an efficient mechanism of collective insurance to manage financial crises in developing countries, as the current system is based on IMF lending that is too small relative to the size of today's disturbances and carries excessive conditionality. The world also lacks a mechanism to orderly renegotiate international debts similar to domestic bankruptcy courts. According to this view, the only rational response of developing countries to this institutional deficit was to "self-insure" themselves against crises by accumulating large amounts of foreign exchange reserves, a policy that included saving a larger proportion of recent commodity price booms and absorbing through reserve accumulation a larger proportion of excess supply of external financing during the 2004-2007 boom than in the past.

The role of the US as the "consumer of last resort" during the Asian crisis had dramatically increased the US current account deficit. The very high deficits in later years made one feature of the international monetary system patently clear: the lack of discipline imposed on the major reserve currency country by the current system, in which a *national* currency is used as the major global currency, which allows the US not only to pay for its deficit by flooding the world with dollar assets but also to essentially impose its monetary policy on the rest of the world. However, this major deficiency of the international financial architecture is not generally recognized in current debates.

2. Intensity and spread of the crisis

Viewed from the perspective of the US financial markets and policy responses, the crisis has had four distinct phases. The first started with the collapse of the subprime market and, more generally, asset-backed securities in August 2007. The response of the authorities in the US and Europe was to activate the role of central banks as "lenders of last resort" by coordinated efforts to make emergency financing to banks more readily available and at lower interest rates. The US also adopted an early though limited fiscal stimulus. The second phase started with the collapse and rescue of Bear Stearns in March 2008. The lack of trust among financial institutions in the quality of their balance sheets increased sharply after that event, generating a much greater use of the available central bank credit lines.

The collapse of Lehman Brothers during the weekend of September 13-14, 2008, marks the beginning of the third and, in terms of financial markets, the most dramatic phase of the crisis. During the week that followed, financial markets came to total paralysis – a "credit freeze", including of interbank lending and commercial paper. Many other major institutions went bankrupt in both the US and Europe and were generally rescued or taken over by governments, in a major correction with what was very soon perceived to have been a major policy mistake (to let a systemically important institution, such as Lehman, go bankrupt). Authorities in industrial countries responded with an even more massive increase in central bank credit, including through many new lines, strengthening deposit insurance, designing different schemes to capitalize financial institution with public sector funds and, to a lesser extent, buying toxic assets. Curiously, policies to alleviate household debts, particularly those associated with mortgages, did not figure out in the policy packages.

The critical phase was overcome in late October/early November, as reflected in renewed interbank lending and the reduction of interest rates in many segments of the market. This may be taken as the beginning of a fourth phase, in which financial panic was overcome but financial institutions continued to be seriously undercapitalized or are outright bankrupt but continued to operate under the implicit promise that at the end they will be bailed out. In terms of new policy actions, the most remarkable is the shift by major central banks towards "quantitative easing", that is, the outright increase in the money supply once central bank interest rates are brought down to zero (or near zero). What this implies is that central bank lending is either used in a straight way to finance fiscal deficits (not the common action so far) and the private sector. In the latter case, what it implies is that the focus of the central bank shifts from increasing *liquidity* to reactivating *lending* and reducing the interest rates that borrowers pay.

An economic slowdown was already visible but was not dramatic during the first two phases of the crisis. Although the slowdown was stronger in Europe, there was a tendency to underestimate it in political circles, a fact that was reflected in the much more conservative attitude of the European Central Bank (less so of the Bank of England) and the lack of fiscal stimulus. Responses in the US were more aggressive in both fronts. The dramatic recession in the industrial world that followed the financial paralysis of September 2008 defeated expectations by broad margins. The rate at which the GDP of industrial countries fell in the last quarter of 2008 and which continues to fall in the first quarter of 2009, of 6 to 7% in annual terms, is closer to a "depression" rather than a "recession", though the difference between the two have never been quite clear.

Although developing countries were partly hit by the first phases of the financial crisis, particularly through reduced availability and higher costs of borrowing, they continued to grow relatively fast during the first semester of 2008 thanks to booming commodity markets and the perception that risks of lending to them were relatively low due to their high levels of foreign exchange reserves. The change in direction of commodity markets in mid-2008 may be seen, therefore, as the turning point in the spread of industrial country recession to the developing world. In any case, the September 2008 crash was a more important shock, which was transmitted globally through two major channels: the collapse of international trade (including the collapse of commodity prices) and the paralysis of private capital markets. We know much less about the strength of a third channel of transmission, the fall of remittances, which is very important for many parts of the developing world.

Although consolidated figures are not available, the reduction in the value of international trade in the last quarter of 2008 seems to have been close to 20% vis-à-vis the last quarter of 2007. This means that current World Bank projections of the reduction of world trade in real terms, in the order of 3% in 2007, are a clear underestimation. Commodity prices, which had already fallen by 23% during the third quarter of 2008, fell by 47% in the last quarter, for an accumulated fall between June and December of 59%, according to the SP Index. The prices of oil and minerals, which had experienced a stronger boom since 2004, also experienced the sharpest fall. An implication of the collapse of international trade is that countries more open to international trade and, particularly, manufacturing exporters, were hardest hit. This explains why Japan and Germany ended up experiencing very strong recession, and why most of the first generation of Asian tigers (Korea, Singapore and Taiwan, in particular) and Mexico were also strongly affected. Even China experienced a sharp fall of exports, which has continued in early 2009, and a virtual GDP stagnation in the last quarter of 2008. Oil and mineral exporters were partly able to cushion the initial storm thanks to the massive foreign exchange reserves and resources accumulated in stabilization funds during the boom.

The paralysis of private finance hit hard the middle income developing countries, including the so called "emerging economies". A critical issue in this regard is the paralysis of trade financing, which has contributed to the collapse of world trade. Outflows of more volatile capital were severe in the developing world during the last quarter of 2008, leading to sharp depreciations of currencies. The shock was particularly severe in Central and Eastern Europe, which had run risky macroeconomic policies during the boom, indeed reminiscent of Latin American patterns in the past. This was reflected in large current account deficits, weak foreign exchange reserves, high external debt ratios and lending in domestic markets in foreign currencies, which made debtors very vulnerable to currency depreciations during the crisis. In contrast, although East Asia and Latin America were also hit, the significant accumulation of foreign exchange reserves, the reduction in external indebtedness and healthier financial systems (thanks to stronger regulation adopted after their own previous crises) provided a stronger defense to financial contagion. Going forward, access to private finance is critical for major emerging market corporations that are heavily indebted in international markets. So, if the financial paralysis continues, the rotation of the corporate debts will become a major problem for several countries. Governments are this time in a generally healthier position.

As pointed out, only partial information is available on remittances. The worst case scenario projected by the World Bank is a 6% fall in remittances, which may also turn out to be an underestimation. For households that receive remittances, there might be a gain in purchasing power in countries that have experienced a depreciation of their currencies. This effect is absent in countries that are dollarized or euroized and has the opposite sign if the country that is the source of the remittance experiences depreciation (the case of Central Asian migrants to Russia).

3. The macroeconomic policy response

The global recession calls for a strong policy response. The strong social impacts are already evident, and rapidly mounting. ILO has estimated that the crisis will increase unemployment in 2009 by 30 to 50 million people, and that there will be a much larger increase in the number of working poor (up to 200 million, based on a two dollar a day line), possibly the most important outcome in developing countries, where rising informality or a return to rural areas are more important mechanism of adjustment of labor markets than open unemployment.

Given the tendency so far to underestimate the intensity and length of the recession, it is important to prepare for the worst case scenario in the absence of strong policy action: a lengthy recession followed by a fragile recovery. Its economic and social costs would be immense, as the experience Japan and Latin America during their "lost decades" indicates, as well as that of sub-Saharan Africa during its "lost quarter century". Its international and domestic political implications are also deep. Nationalism is clearly on the rise, and is leading to a resurgence of protectionism under different guises. The most undesirable outcome of the current crisis would undoubtedly be repeating, even in a moderate way, the beggar-thy-neighbor policies that magnified the effects of the Great Depression. Mounting political tensions within countries will also be the rule rather than the exception, stressing the capacity of democratic regimes to process conflict in an institutional way.

The European scenario is particularly problematic. Growing tensions between Western and Central and Eastern Europe are already evident, and the likelihood of a split in the European Union or the exit from the euro area of some countries are now likely scenarios, undreamed of before the crisis. The growing weakness of the eurozone (and likely costs of a crisis in the Monetary Union) is undoubtedly behind the reluctance of EU countries to provide more fiscal stimulus, indicating that saving the monetary union is top in their agenda. In any case, the Maastricht criteria that rule the euro area have shown again to be improperly designed and should be renegotiated, particularly by shifting the attention from the current to the structural fiscal deficit and possibly postponing or even eliminating any caps on public sector indebtedness.

Current conditions call therefore for expansionary monetary, credit and fiscal policies in all industrial countries. Europe has clearly lagged in all these dimensions relative to the US and Japan, generating tensions within the G-7. Indeed, the European Central Bank has lagged significantly behind in its policy easing, and the average size of the European fiscal packages, of the order of 1% of GDP, are much smaller than IMF recommendations (a world average stimulus of 2%, still an underestimate for many analysts, which consider that a 3 to 3.5% of GDP stimulus a more appropriate magnitude) and those of the US (slightly over 2% per year), with Japan somewhere in between. Developing countries should also be part of the solution, and should adopt equally expansionary policies. China has led the way but other developing countries will find it more difficult to do so without financial support. Finally, it is quite clear that there is no institutional framework in place to provide the global coordination required.

Industrial and developing countries with external surpluses should lead the way in adopting expansionary policies. Relying excessively on the expansionary policies of the world's major deficit country, the United States, runs the risk of igniting (or, rather, reigniting) fears of disorderly adjustment to global imbalances, which would add another highly undesirable dimension to the current crisis –or abort an eventual US-led world economic recovery. More generally, relying on an export-led recovery seems highly undesirable in the face of the ongoing collapse of world trade, as it may encourage the already visible protectionist pressures in many countries.

The composition of the policy packages in terms of the monetary/fiscal mix is also critical. The strong adjustment in the portfolios of all economic agents (including households) and the broad based desire to reduce indebtedness (financial deleveraging) indicates that the demand for credit by private agents will be weak, even if the health of the financial sector is restored. The other side of this coin is that private sector demand (both consumption and investment) will continue to be weak. This has been the experience of financial crises in many countries. Therefore, although restoring credit is a priority, and plays a crucial role in some case (short-term commercial credit, including for international trade), monetary and credit stimulus is likely to be insufficient.

This is the reason why expansionary fiscal policies are essential, an area where policy responses have been much weaker. Furthermore, since the objective is to increase aggregate demand, additional public sector spending policies are preferable to tax benefits. A major concern of fiscal conservatives is the effect fiscal stimulus will have on public sector debts. This concern is probably overdone. For countries paying long-term real interest rates of around 2%, even a 50% increase in debt ratios (a high estimate) would increase the long-term fiscal costs by only around 1% a year, probably a low cost for avoiding a long recession. Furthermore, a long recession will lead anyway to a sharp increase in public sector debts, as the Japanese experience indicates.

The fact that many developing countries have accumulated large amounts of foreign exchange reserves in recent years, and have lower external and public sector debts than during previous crises, imply that they *do* have more room to maneuver to adopt expansionary policies than in the past. But there is a consensus that this is insufficient, and that new financing mechanisms have to be available to allow the developing world to play a central role in the global recovery. The problem here is the size of the retrenchment of private capital from developing countries vs. the size of existing multilateral financing mechanisms. According to the Institute of International Finance, emerging markets will face net negative private credit flows of $30 billion in 2009 vs. net positive flows of $632 billion in 2007. International Financial Institutions will only add $28 billion in financing –i.e., about 4% of the shortfall! So, a major initiative to increase the availability of multilateral financing is required.

In the case of the IMF, the best option is a major countercyclical issue of Special Drawing Rights (SDRs), of the order of at least $500 billion, which give developing countries new foreign exchange reserves equivalent to slightly under 40% of the allocation and would increase the lending capacity of the Fund, if allocations to industrial countries were made available to the Fund to increase its financing. Without a major rethinking of IMF conditionality, however, these resources may remain idle, as many countries would be unwilling to use Fund facilities. Therefore, a significant rethinking of IMF conditionality would be required for this strategy to work. In the case of the multilateral development banks (MDBs), stretching their lending capacity is one option, being pursued by most of them, but additional capitalizations are also required. For poorest countries, ODA with a significant component of transfers is required, in order to avoid the debt buildup, a highly undesirable situation after the major debt programs that were implemented in recent years (the Heavily Indebted Poor Countries and the Multilateral Debt Relief Initiatives). Multilateral financing and additional ODA are particularly important for those countries that have a more limited room to maneuver, due to the imbalances accumulated during the previous boom, the capital outflows and/or the collapse in their terms of trade.

A major issue in current debates is whether the large demand for funds by industrial countries to fill their fiscal will end up reducing the supply of capital to developing countries. This "crowding out" hypothesis ignores, however, that rising public sector debt is the counterpart of the large reduction in private sector debts (the phenomenon called de-leveraging), and are thus compatible with a low interest rate environment so long as monetary policy is consistent with that objective. A more problematic issue is the change in the riskiness of developed vs. developing country debts, an issue that will be addressed below.

A final pending issue is the institutional framework for macroeconomic policy coordination. The obvious solution in this regard is to place the IMF at the center of this effort rather than continuing to rely on informal mechanisms, such as the G-7 or G-20. This would not only provide a clear institutional structure but also give developing countries a voice on the associated processes. Indeed, the current crisis is the opportunity to put the IMF back at the center of global macroeconomic policymaking, as its original design envisioned. Such coordination has tended to take place outside the Fund since the breakdown of the original Bretton Woods arrangements in the 1970s.

4. Financial sector bailouts and regulatory measures

As we have seen, monetary and credit policies have been more aggressive than fiscal policies. Financial sector bailouts fall somewhere in between. And whereas Europe has been dragging its feet in fiscal policy, the US is the reluctant agent in this case. The major initial difficulties following the September 2008 crash had strong political tones. In the US, the bailout package proponed by the Bush administration was approved with the support of the opposition, as a majority of Republicans refused to do so. In Europe governments announced in a disorganized way a series of initiatives that competed with each other, particularly in terms of deposit insurance. The response effort was placed on a better track after Great Britain announced its bailout package on October 7.

The most important measure is the capitalization with public funds of several financial institutions, particularly those of systemic importance. There is now broad recognition that a temporary nationalization of financial institutions can actually be the best and least costly instrument in the long-term, as the initial capital injections can be partly or fully recovered when these institutions are re-privatized later on. The major issue has been the reluctance in the US to take large stakes in the banks and even to use the term "nationalization" (curiously, even when well known Republicans are now even recommending it!). The second ingredient of these packages is enhanced deposit insurance and government guarantees on new lending. The third is the creation of mechanisms to buy "toxic assets". However, although this was the center of attention of the initial package proposed by the Bush administration, it was later abandoned due to the technical difficulties in valuing complex and heterogeneous financial assets. The Obama administration proposed in February 2009 a new initiative of this type, based on public-sector partnerships, which has not yet been put in place. The rescue of Citibank in November 2008 and the new British package of January 2009 adopted a mix of the second and third types of interventions, as governments assumed a partial public sector guarantee on bank losses from toxic assets. Curiously, as pointed out, few initiatives have been taken on a fourth area, easing the debtors' burden, particularly in the case mortgages, though an initiative in this area was announced by the Obama administration in February 2009.

A major effort to stabilize financial institutions is crucial, to avoid a protracted distrust in financial institutions that affected Japan during its lost decade. An equally important problem is, of course, the fiscal cost and the transparency of the associated bailout packages, which can result in massive subsidies to bankrupt investors. This is, in fact, a major problem in partial nationalization and in the purchase of toxic assets and issuance of government guarantees, as there is a strong incentive to shift to the government the riskiest assets. On the other hand, full nationalizations may end up fully transferring the risk for previous risky operations to the state, as the huge losses associated with the credit default swaps (in fact, a sort of credit insurance) issued by the American Insurance Group (AIG) indicates. Full transparency must therefore be a central issue in bailout operations.

An equally important issue is the distortions in international finance and trade that the bailouts are generating. The fact that industrial countries can provide large amount of resources to rescue their financial system and offer guarantees that developing countries cannot, generates new asymmetries in the international system. One effect is that the risk premia that developing countries pay for their debt will remain high. Aside from the financial implications, this distorts competition in international trade, particularly when subsidies are sectorial character, such as the subsidies granted to the automobile sector in several countries. Fiscal and bailout packages are also bringing with them protectionist clauses, such as the "Buy American" provisions included in the US fiscal stimulus and the preference for hiring Americans when financial institutions receive US funds. These distortions make even more difficult to re-launch WTO negotiations.

A major advance in the international debate has been the recognition that the current crisis is clearly associated with inadequate regulation and supervision of financial activities. It is in this area that the G-20 has been most useful, particularly in agreeing on certain principles. The first agreed principle is that regulations must be comprehensive or at least much broader in scope, to avoid the massive loopholes through non-banking intermediation that led to the current turmoil. This includes regulating hedge funds, security dealers and the types of transactions that led to the current crisis, particularly securitization and derivatives, and force all the markets to be open and transparent and thus limit over-the-counter operations. It is also agreed that systemically important financial intermediaries must be subject to particularly harsh supervision, and perhaps to stronger regulatory standards. It is unclear, however, what this will imply for the major current framework on regulation, Basel II, and its specific focus, excessive reliance on the internal models of financial institutions (self-regulation), which has already shown how perilous it can be. There is also broad agreement that credit rating agencies should be regulated.

A second major advance has been the recognition that prudential regulations should have a counter-cyclical focus, thus forcing financial institutions to accumulate increasing capital, provisions (reserves) and liquidity cushions during booms. It is likely that this will also result in absolute limits on leverage (the ratio of assets to the capital of institutions), obviously variable by the nature of the institution or operations involved. Pricing assets according to their market value (when it is available) is likely to be preserved for reasons of transparency, but this can be made consistent with the nature of the funding used by the financial institution and with the adoption of mechanisms (such as counter-cyclical loan-to-value ratios) to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from feeding into the credit squeeze.

Consumer protection also figures out prominently in some of the proposals that are on the table, such as the recommendation to create a Financial Safety Commission in the US. In the light of amount of toxic mortgages and highly risky investment vehicles offered to unsophisticated households during recent years, this function should be clearly enhanced, as should be the principle that financial instruments should be as simple as possible, as complexity brings with it information problems and difficulties for markets to price the associated instruments. The current wave of bailouts is likely to result in higher concentration in the financial industry. Restricting monopoly power should therefore figure out prominently, in new regulation. Finally, and most importantly, it is essential to guarantee that the prudential regulations that are in place are actually used, and that supervision is actually done with the highest standards. As pointed out, some of the major failures leading to the current crisis came on this area. So, increased surveillance and clear accountability mechanisms would also have to be introduced in all regulatory bodies, both national and international.

As in the case of macroeconomic policy coordination, one of the major gaps in the current regulatory debate relate lie in the institutional frameworks that should be put in place. Creating a single world financial regulator is probably not viable or, for that matter, desirable, given different regulatory traditions around the world. So, the system that is designed in this area should be based on a well functioning *network* of national and regional authorities (which is still missing in the EU) and include truly international supervision of financial institutions with a global reach (such as the college of supervisors proposed by the G-20). There seems to be agreement that the IMF should *not* be at the center of the regulatory system. The Financial Stability Forum and the Basle Committee on Banking Supervision are better placed. However, despite their recent broadening of membership to include developing countries, a major problem of these institutions is the control by major industrialized countries, which even abrogate for themselves the right to choose who is a member. So, the design of truly representative institution that serves as the apex of world financial regulation should be in the cards. One alternative would be to give this responsibility to the Bank of International Settlements, making it a truly global institution with stronger political accountability.

5. The broader agenda

Current international negotiations have concentrated on the coordination of macroeconomic policy packages and strengthening financial regulation. These issues do not exhaust, however, the agenda of international financial reform, which include at least three other topics: the need for a new international monetary or global reserve system, the role of capital account regulations in the global order, and the need for a debt workout mechanism at the international level. Institutional issues are equally important. The preference for informal organizations with restricted membership chosen by the major industrial countries is problematic, as is the inadequate representation of developing countries in international economic decision making in general. Not surprisingly, most of the issues that are off the table are those of particular interest to developing countries.

The current international monetary system, which followed the dual gold-dollar system created at Bretton Woods, is a essentially based on the use of a *national* currency (the US dollar) as a global currency. It is secondarily a system based on the competition among national currencies (regional in the case of the euro) as reserve currencies. This system is inequitable and unstable. It is inequitable because it forces developing countries to transfer resources to the countries issuing reserve currencies. This transfer that has actually increased through time due to the realization by developing countries that "self-insurance" in the form of large foreign exchange reserves is the only defense they have in a world of acute financial instability.

The system is also unstable because it is plagued by cycles of confidence in the US dollar: periods in which the US runs large deficits and floods the world with dollar assets, followed by others in which it tries to restore the credibility in the dollar as a reserve currency. During both phases of this cycle, the US adopts its monetary policies without any consideration as to their international impact. A system based on competing reserve currencies, such as the one we may be moving towards, would not solve the inequities of the current system and would add another element of instability: that among the exchange rates of alternative reserve currencies.

The deficiencies of current arrangements are why the world monetary system should be based on a truly global reserve currency: a fiduciary currency backed by the central banks of the world. This is what was hoped for when the Special Drawing Rights (SDRs) were created in the 1960s. This process must be completed, by either transforming the SDRs into such global currency or creating a global reserve asset that could be used in some private financial transactions. Among other advantages, this system would provide a mechanism for the IMF to play a more active role during crises, by issuing SDRs in a counter-cyclical way. Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance large official support to developing countries during the current crisis. This would be the global equivalent to what the major central banks of the world been doing on a massive scale since September 2008. Regular issues of SDRs would also bring the size of IMF to one more consistent with the magnitude of today's disturbances. As already pointed out, a major reform of IMF conditionality is necessary anyway to make it attractive again for developing countries to use its facilities rather than rely on "self insurance" through foreign exchange reserve accumulation.

In relation to regulations of capital flows, it must be recalled that the IMF was created on the presumption that capital account regulations could be broadly used if necessary for domestic macroeconomic and financial management. The broad based trend towards capital market liberalization has facilitated the spread (or contagion) of both booms and crises. Since developing countries are subject to pro-cyclical swings (floods of capital during booms followed by scarcity of financing during crises), they also have limited policy space to counteract such swings. Furthermore, since they usually borrow in foreign currencies, exchange rate depreciation during crises generates significant wealth losses (as several countries of Central and Eastern Europe have rediscovered in recent months). Under these conditions, external payments crisis are easily transformed into domestic financial crises.

In the ongoing debate on the role of stronger financial regulation, there should therefore be an open discussion on the use of *capital account* regulations to strengthen financial stability. Those regulations can be useful to mitigate the contagion of both booms and crises, playing therefore the role of "circuit breakers" in international finance, in the same way such breakers play a useful role in electricity networks. They can also help improve financial stability in individual countries. Therefore, the regulatory structure that must be developed for financial stability should include provisions that apply to cross-border capital movements, such as: reserve requirements (i.e., deposits in central banks) on cross-border flows to prevent excessive capital inflows and, particularly, excessive short-term inflows during booms; minimum stay periods, similar indeed to those that mutual impose on investors to guarantee the stability of their deposits; and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies. In this regard, the IMF should be encouraged not only to tolerate but actually advise countries on what regulations could play a positive role under a given circumstance.

The discussions that followed after the Asian crisis indicated that the lack of a regular institutional framework to manage debt overhangs at the international level –i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding—is one of the major deficiencies of the current international financial architecture. The only regular institutional mechanism in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on ad-hoc mechanisms, such as the Baker and Brady Plans of the 1980s and the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief (MDRI) Initiatives since the mid-1990s, or on traumatic individual debt renegotiations. The problem of all these mechanisms has been that they generally come too late, after high indebtedness has had devastating effects on countries. The system is also inequitable, as it does not treat all debtors or all creditors with uniform rules.

The discussion of the new international financial architecture should solve this problem by creating an international debt court, which would serve both as mediator and eventual arbitrator of sovereign loans and, possibly, private sector loans with systemic implications on individual countries. Negotiations would be triggered by defaults form debtor countries, and should be based on the principle of a "fresh start", which would leave a sustainable debt burden that would allow borrowers to make a (relatively) swift return to markets. Furthermore, active use of multilateral development bank lending and guarantees could play a role in financing countries while negotiations are in place and supporting their return to markets.

The major institutional drawback of current initiatives is the tendency to rely on informal structures. These arrangements are problematic, not only because they exclude small and medium-sized countries but also because they lack institutionalized mechanism to guarantee a follow up to the agreed decisions. This is why that the governance system that the current process should design must be based on *representative institutions*, not on any G, which will always face problems of legitimacy. And it is necessary, for the same reason, to involve the United Nations, the most representative global institution, perhaps by taking the step, recommended in the past by many, of creating a Global Economic Council in the United Nations, with effective powers of coordination over the system of global economic and social governance. Such body would have to be based on a constituency system, to allow the indirect representation of small and medium-sized countries while keeping the size of the Council small enough to facilitate decision making. It would also have to take into account the different weight of nations, such as the system on which the IMF and World Bank are based (of course, with significant redefinition in the way these "weights" are measured), rather than simply on a "one country one vote" system on which the UN is built.

This process should, furthermore, place at the center of international reforms efforts the discussion of voice and representation of developing countries in international economic decision making and norm setting. This includes not only the IMF, the only place where some (though extremely modest) reforms have been adopted, but also the World Bank (where such discussion is in place), the Bank of International Settlements, the Basle Committee on Banking Supervision and other world regulatory bodies.

Finally, the institutional design should adequately take into account the role of regional institutions. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions will provide a better system of governance than arrangements based on single global organizations. Regional and sub-regional institutions give stronger voice and sense of ownership to smaller countries, and are therefore more likely to respond to their demands. In some areas this is recognized today, such as in the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world sub-regional (in Latin America and the Caribbean, in particular) and inter-regional banks (the Islamic Development Bank).

Its application is particularly urgent in the monetary area, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund, and support their creation in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds –that is, a system closer in design to the European Central Bank or the Federal Reserve System than to the unique global institution it now is. Similar institutional design could be adopted for macroeconomic policy coordination, financial policies and for the international debt court.