A DEVELOPMENT FRIENDLY REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

José Antonio Ocampo [*]

The financial crisis has shown how dysfunctional the current international financial architecture is to manage today's global economy. The need to govern globalization has never been clearer, but at the same time the institutional arrangements that we have had never been so impotent. The calls for deep reforms of such architecture and even for a second Bretton Woods Conference are, therefore most welcome. Similar calls for reform were made after the Asian and Russian crises, which engulfed most of the developing world in deep recessions, but they led to at best marginal reforms. The fact that this time the industrial countries are at the center of the storm may lead them into action, but also creates the risk that measures of direct interest to developing countries may be marginalized in the current debate.

There are also two fundamental problems with these calls. The first is that they lack scope and, in some cases, even contents. Most of the proposals –for instance, those of the November G20 meeting— relate to macroeconomic action to counter the world recession and to regulatory reform, and in both cases they are largely confined to national policies rather than to the reform of the global architecture. Second, the process started the wrong way, by excluding most countries from the table. It is obviously good for

[*] Professor and co-President of the Initiative for Policy Dialogue at Columbia University. Former Under-Secretary General of the United Nations for Economic and Social Affairs and former Minister of Finance of Colombia. Paper prepared for the workshop organized by the North-South Institute on "Policy Responses to Unfettered Finance", at Columbia University, New York, February 12-13, 2009. This paper draws from the document written by the author for the South Centre and issued as a statement of its Board on October 29, 2008. Financial support from the Ford Foundation is kindly acknowledged.

major industrial countries to show (no doubt, late) leadership, but no fundamental reform can take place if it is not an *inclusive process*, and it does not lead to the design of representative institutions. In short, global institutions, not ad hoc groupings of countries, should be at the center of the reform effort.

History has shown that crises represent opportunities to redraw, even in radical ways, old arrangements. The current opportunity should not be missed. It should be based on an inclusive process led by representative institutions and encompass all areas of the current architecture: macroeconomic policy coordination, regulatory reform, revamping of the IMF, fully exploiting the potential counter-cyclical role of development cooperation, creating an international debt court, and giving a clear role to regional financial institutions in the designed architecture.

1. The process and the institutional design that it develops must be inclusive

It is important for major countries, including now major developing countries, to show leadership, but a desirable reform process must give voice to industrial and developing countries alike, and to both large and small countries. So, the major is the reform process is not to replace the G7/G8 by another G. The G20 is certainly better in this regard, but it is still an *ad hoc* arrangement, where major developing countries (e.g., Nigeria), major industrial countries (e.g., up to now Spain) and, particularly, medium and small-sized countries are unrepresented.

This also means 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 and Social [Security] Council in the United Nations, with effective powers of coordination over the system of global economic and social governance. Such body would probably have to be based on a constituency system that takes into account the different weight of nations, such as the system on which the IMF and World Bank are constituted (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. The UN process on Financing for Development could be the institutional framework to launch a participatory process leading to such reform of the global financial architecture, with the backing and close collaboration of the United Nations, the Bretton Woods institutions and the Bank of International Settlements.

This process should, furthermore, place at the center of the debate the discussion of voice and representation of developing countries in international economic decision making and norm setting, as mandated by the Monterrey Consensus approved in the 2002 UN Conference on Financing for Development. 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.

2. A coordinated global macroeconomic policy package must be adopted

The global recession now under way calls for a strong policy response. This means clear expansionary monetary, credit and fiscal policies in all industrial countries.

Europe and Japan have clearly lagged in all these dimensions relative to the US. Developing countries should also be part of the solution, and should adopt equally expansionary policies. The fact that many of them 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.

However, the strong retrenchment of private capital from developing countries implies that support from multilateral institutions (the IMF and multilateral development banks) and bilateral development cooperation would be crucial to facilitate countercyclical policies in the developing world. The major problem is the scale of such financing. 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. IFIs 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, which as I will argue below can only take place through a major countercyclical issue of SDRs.

Multilateral financing, and additional ODA in the case of poor countries, 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. But this means that it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies during crises.

The composition of the policy packages is also essential, both in terms of the monetary/fiscal mix as well as on the relative size of packages adopted by different countries. The strong balance sheet adjustment and associated financial deleveraging taking place in the private sector of the industrial world, and particularly in the United States, means the demand for credit by private agents may be weak, even if the health of the financial sector is restored. This enhances the need for expansionary fiscal policies. To the extent that tax benefits are likely to be saved rather than spent, public sector spending policies are also clearly preferable.

Furthermore, 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 international trade, as it may encourage already visible protectionist pressures in many countries. The most undesirable outcome of the current crisis would be repeating, even in weaker forms, the beggar-thy-neighbor policies that magnified the effects of the Great Depression.

The IMF should be placed at the center of global macroeconomic policy coordination. This is the only way to provide a clear institutional structure for such coordination and 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, including in recent decades through the role assumed (in a very weak way, in any case) by the G7. The multilateral surveillance on global imbalances launched by the Fund in 2006 was an interesting step in that direction, but it lacked binding commitment by the parties and an accountability mechanism.

3. The regulatory deficit of global finance must be corrected

The magnitude of the current crisis is clearly associated with inadequate regulation and supervision of financial activities. Since the Asian crisis, it became an established criterion that financial liberalization must be accompanied by stronger prudential regulation and supervision. This principle was applied in many parts of the developing world but was entirely disregarded in the United States, where further liberalization was accompanied by deregulation and weak supervision of financial intermediation.

The discussion on regulation must start by agreeing on basic regulatory principles. The first principle is that regulations should have a strong counter-cyclical focus, thus avoiding excessive indebtedness (leverage) and forcing financial institutions to accumulate increasing capital, provisions (reserves) and liquidity cushions during booms. Absolute limits on leverage should be part of the solution. This also implies that, when pricing assets according to their market value to maintain transparency, the system must have 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.

Regulations must also be comprehensive, to avoid the massive loopholes through non-banking intermediation that led to the current turmoil, and that has in fact been central to increased systemic leverage during booms that preceded financial meltdowns in many countries. This will also include regulating the types of transactions that led to the current crises, particularly securitization and derivatives, and force all the markets to be open and transparent and thus limit over-the-counter operations. Systemically important financial intermediaries must be subject to particularly harsh supervision, and perhaps to stronger regulatory standards. Reliance on the internal models of financial institutions, the major focus of Basel II, should be discarded. It has already shown how perilous it can be, and how the use of similar risk models by financial institutions can lead to greater instability.

To these principles we must add well established ones: consumer protection, restricting monopoly power (a major issue looking forward, as private finance is experiencing rapid concentration), and encouraging portfolio diversification. Suffice is it to say that even these well established principles were not followed in recent years. The first of these functions should considerably enhanced to avoid the supply of toxic mortgages and highly risky investment vehicles offered to unsophisticated agents during the recent boom in many countries.

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 G20). The IMF should *not* be at the center of the regulatory system. The BIS and the Basle Committee are better placed, but this would require a fundamental reform to broaden (preferably universalize) their membership and avoid two major problems that the Basle Committee has faced in recent years: the lack of representation of developing countries, and the capture of regulation by large multinational banks. Clear accountability mechanisms would also have to be introduced in all regulatory bodies, both national and international.

4. The IMF should be revamped

Four essential reforms of the IMF should be part of the agenda. The first, as pointed out, is placing this institution at the center of global macroeconomic policy coordination. The second is creating a meaningful and truly global reserve currency. The third is improving the crisis response effort. The fourth is a more active use of capital account regulations.

The IMF was created on the basis of the dual gold-dollar system (the so called "gold-exchange standard"). This system collapsed in the early 1970s and was replaced by a system based on fiduciary dollars or, perhaps, on competing fiduciary reserve currencies –i.e., on the use of a *national* currency (or national and regional currencies) as a global currency. This system is inequitable and unstable. It is inequitable because it forces a transfer of resources from developing countries to the developed nations that provide reserve currencies –a 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 can rely on in a world of acute financial instability.

The system is also unstable because it is plagued by cycles of confidence in the US dollar, in which the US alternatively adopts expansionary policies, which reflect the fact that the system does not impose firm macroeconomic discipline on the reserve issuing country, followed by contractionary policies to restore the credibility in the dollar as a reserve currency. During both phases of this cycle, policies of the reserve currency country are adopted without any consideration as to their international impact. A system based on competing reserve currencies would not solve the inequities and instability of the current system and would add another one: the instability of the exchange rates among major reserve currencies. Indeed, this problem is already partly present in the current system.

The inequities and instability of current arrangements is 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 at least 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 FED has been doing on a massive scale since September, expanding the monetary base by close to one trillion dollars –with no consideration, by the way, as to whether this is consistent in the long run with the role of the dollar as a global reserve currency. This has not been a major problem in the short run, due to both “flight to quality” and the transfer of resources to the US to facilitate the withdrawal of funds from financial intermediaries which is part of the ongoing deleveraging process.

The third issue is the need for the IMF to lend during balance of payments crises rapidly and without the overburdening conditionalities of the past, particularly when the sources of the crises are a rapid reversal of capital flows or a sharp deterioration in the terms of trade. This means putting in place a preventive credit line for capital account crises and making active use of the compensatory financing facility (which has not been used in recent years due to the associated conditionalities) and of the Poverty Reduction and Growth Facility to manage the adverse terms of trade shocks faced by low-income countries. The new Short-Term Liquidity Facility created by the IMF in October 2008 (in a sense, as a successor of the defunct Contingency Credit Line) is a positive step to solve the first of these problems, but it runs the risk of unduly dividing developing countries in two categories: those with good and those with bad policies, with significant additional risks for the latter. This implies that the IMF would act more like a central bank, providing liquidity in an agile way, the way central banks have actually been providing funds in industrial countries on a massive scale in recent months. As indicated, the financing for such liquidity could be a large counter-cyclical issue of SDRs.

The current IMF agreement does not commit countries to capital account convertibility and thus leaves them with full autonomy to adopt capital account regulations, either to restrict excessive capital inflows during booms or to control capital flight during crises. The evidence of strong linkages through which both financial euphoria and panic are transmitted worldwide indicates that it would be wise to make more active use of capital account regulations. So, the Fund should be encouraged not only to tolerate but actually advise countries on what regulations to impose under given circumstances. Indeed, the regulatory structure that must be developed to manage financial stability in the global era should include provisions that apply to cross-border capital movements, such as: generalized reserve requirements on cross-border flows, minimum stay periods, and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies.

5. The counter-cyclical role of development cooperation should also be fully utilized

A large increase in Official Development Assistance (ODA) to low income countries can play an important role, not only to combat poverty but also to contribute to the generation of aggregate demand at the global level. Meeting existing ODA commitments (which will face strong competing fiscal demands in industrial countries) but also making additional aid available is particularly important to avoid contractionary policies in the poor countries in the face of a deterioration of their terms of trade associated to the collapse of commodity prices.

Past crises have also shown that multilateral development banks (MDBs) can play an essential role when private financing dries up. The major problem, as we have seen, is the scale of their resources. So, a major initiative to increase the resources available to multilateral development banks is crucial. Additional capital injections are one solution.

Another one is to allow these banks to benefit from the counter-cyclical issue of SDRs, by authorizing the IMF to buy MDBs' bonds.

Crises, including the current one, have also shown that one particularly problematic issue that developing countries face is the curtailment of commercial credit available to exporters, which then becomes an additional contractionary effect and severely limits an essential mechanism through which deficit countries can recover from crises. So, the launching by MDBs of a large scale program of commercial lending should be at the center of the crisis response efforts. MDBs can also play a role in risk mitigation by operating as "market makers" for innovative instruments, such as GDP and commodity-linked bonds, and move fully (or even completely) into lending to developing countries in the national currencies of recipient nations.

6. An international debt court must be created

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.

This is also true of the Paris Club, due to its traditional reliance on sequential debt rescheduling, which again means that countries are left with debt hangs for excessively long periods. The system is also inequitable, as it does not treat all debtors or all creditors with uniform rules. Even Paris Club creditors regularly complain that private lenders do not follow their agreements. Unilateral renegotiations can also lead to an unfair treatment of borrowers depending on their weight and influence.

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 both public and private sector international loans. Privately-run restructuring mechanisms, based on the active use of collective action clauses, are clearly insufficient, as debtors would delay using the mechanism to avoid antagonizing creditors, debtors would not be uniformly treated, and there would not be a uniform treatment of official and private creditors.

Any workout mechanism that is developed has to start with defaults by debtor countries, which would then trigger negotiations. And the system must be based on the principle of a “fresh start”, allowing borrowers to make a (relatively) swift return to markets. Furthermore, active use of multilateral development bank lending and guarantees could play a role in supporting such a return to markets.

7. The system must rely more broadly on regional institutions

In all of the areas of reform, the global architecture should rely more broadly on 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. This is based on old federalist principles: regional and sub-regional institutions give stronger voice and sense of ownership to smaller countries. These institutions 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 particular, in Latin America and the Caribbean) 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 currently is. Similar institutional design could be adopted for prudential policies and for the international debt court.

The developing countries are in an excellent position to contribute to this task, given their large foreign exchange reserves. Using those reserves more actively for swap arrangements among central banks, pooling them in reserve funds, or using them to support the development of regional bond markets are all mechanisms to multiply the room to maneuver that they provide. These reserves and existing sovereign wealth funds could also be used to create or capitalize multilateral development banks owned by developing countries, and to invest in bonds issued by such institutions. The multiplication and growth of sub-regional development banks and inter-regional banks owned by developing countries are one of the most fertile grounds for South-South cooperation –though an underexploited one.