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South Centre calls for Revamping the Global Financial Architecture

The financial crisis that originated in the United States a year ago has become a global financial crisis unprecedented since the Great Depression. Since mid-September financial markets have collapsed and the world is entering into possibly the worst recession of the post-Second World War period. The credit freeze has severely hit developing countries through increasing risk premia and a severe cut in financing, even of short-term commercial lending. Capital outflows from developing countries have generated a collapse of stock markets and exchange rates and a loss of reserves. Commodity prices have plunged and export orders are being cut worldwide. Even developing countries that were seen as relatively invulnerable to a recession in the industrial world are now feeling the strain.

The financial crisis has shown how dysfunctional the current international financial architecture is to manage the global economy of today, with its myriad of interconnections through which financial turmoil spreads across the world and with its revealed and significant regulatory deficit. In the 1980s, the debt crisis in Latin America, Africa and other parts of the developing world, and in the late 1990s the succession of the Asian, Russian and Latin American crises, had already revealed that something was deeply wrong with that architecture. The industrial world did not understand the need for serious rethinking of the governance of global finance. The fact that this time developed countries are at the center of the storm may now lead them into action. The call by some of them to engage in a reform of the current governance and convene a Bretton Woods II Conference is, therefore, most welcome.

The South Centre wants to join its voice in the call for revamping global finance, based on six lines of action:

1. *The process and institutional design that it develops must be inclusive.* We welcome the initiative of industrial countries but underscore that any discussion process must be inclusive, giving adequate voice to both industrial and developing countries, and to both large and small countries. The governance system that it designs must be based on *representative institutions*, not on any one ad-hoc grouping of countries, be it the G7, a G13 or a G20. We call in particular for a deeper involvement of the United Nations in any reform process, as it is the most representative global institution. Indeed, the follow-up to the Conference on Financing for Development to be held in Doha, Qatar, in late November and early December is the best occasion to launch a participatory process leading to a reform of the global financial architecture, with the backing and close collaboration of the United Nations and the Bretton Woods institutions. This process should include a discussion of the voice

and representation of developing countries in international economic decision making and norm setting, as mandated by the Monterrey Consensus. So far the only reforms in this area were undertaken by the International Monetary Fund (IMF) and were extremely modest.

2. *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 has been 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 must be comprehensive, to avoid the massive loopholes through non-banking intermediation that led to the current turmoil. 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. They should also have a strong counter-cyclical focus, thus avoiding excessive indebtedness (leverage) and force the accumulation of increasing capital and provisions (reserves) during booms. This should also imply that, when pricing assets according to their market value (mark-to-market pricing) to maintain transparency, the system must have mechanisms to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from feeding into the credit squeeze (for instance, variable loan-to-value ratios through the business cycle). 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 new principles we must add well established ones: restricting monopoly power, encouraging diversification and avoiding unsafe financial products. Suffice is it to say that even these well established principles were not followed in recent years

Any 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. 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 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 excessive influence over regulation by large multinational banks. Alternatively, building on these institutions, a new Global Financial Regulatory Authority could be created.

3. *The IMF should be revamped.* Four essential reforms of the IMF should be part of the reform agenda. The first is the creation of a meaningful and truly global reserve currency, which could be based on the IMF Special Drawing Rights (SDRs). This would overcome both the inequities but also the instability that is inherent in a global reserve system based on a national currency. Experience has indicated that this system is plagued by cycles of confidence in the US dollar and by periodic shocks due to policies of the reserve currency country that are adopted without any consideration of their international impact. A system based on competing currencies would also be inadequate, as it does not eliminate the

inequities of the system (the unfair distribution of seigniorage powers and the need to transfer resources from the developing to industrial countries through the accumulation of foreign exchange reserves) and may be even more unstable, due to the volatility of the exchange rate among competing reserve currencies.

The second issue is the need to place the IMF at the center of global macroeconomic policy coordination, not the G7 or in fact any Group. This is the only way to give developing countries a voice on the issue. The multilateral surveillance exercise on global imbalances launched by the Fund in 2006 was an interesting step in that direction, but it has lacked binding commitment by the parties and an accountability mechanism.

The third issue is the need for the IMF to lend during balance of payments crises rapidly and without overburdening conditionalities, particularly when the sources of the crises are a rapid reversal of capital flows and a sharp deterioration in the terms of trade. This means putting in place a preventive credit line for capital account crises (such as the defunct contingency credit line) and making active use of the compensatory financing facility (which has not been used in recent years due to overburdening conditionalities) and of the Poverty Reduction and Growth Facility to manage the adverse terms of trade shocks faced by low-income countries. 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. In the case of the IMF, the financing for such liquidity could be counter-cyclical issues 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, as a fourth issue, the reform effort should encourage the IMF not only to tolerate but actually to encourage and 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.

4. *A coordinated global macroeconomic policy package must be urgently adopted.* The global recession now under way calls for a strong policy response. This means a clear expansionary monetary and credit policies in all industrial countries (which is still missing in Europe) as well as expansionary fiscal policies. Developing countries should also be part of the solution, and should adopt equally expansionary policies. Those countries that have accumulated large amounts of foreign exchange reserves do have more room to maneuver to adopt these policies than they had during previous crises. For those who do not, this implies that it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies.

This also means that a large increase in Official Development Assistance (ODA) to low income countries can play an important role to both combat poverty and contribute to the generation of aggregate demand at the global level. Additional ODA is particularly important to avoid contractionary policies in the poor countries in the face of a deterioration of their terms of trade due to the collapse of commodity prices.

Past crises have also shown that multilateral development banks can play an essential role when private financing dries up. One particularly problematic issue during crises in developing countries is the curtailment of commercial credit available to exporters, which severely limits an essential mechanism through which countries can recover from crises. So, the launching by multilateral development banks of a large scale program of commercial lending should be at the center of the crisis response efforts. No conditionalities should be attached to these credit lines.

5. *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 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. Conditionalities have also been a significant source of problems for several poor countries in the case of the HIPC and MDRI and must be immediately lifted to allow those countries to benefit from these Initiatives. The only regular institutional mechanism is the Paris Club, which deals exclusively with official financing but must overcome its traditional reliance on sequential debt rescheduling, which again means that excessive debt hangs on countries for excessively long periods. 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.

6. *The system must rely more broadly on regional institutions, and developing countries should actively cooperate to create them.* In all of the areas of reform, 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. This is also the system in place in the case of multilateral development banks. A similar institutional design could be adopted for prudential policies or for the international debt court. A denser network of institutions seems better adapted to a heterogeneous international community, and it is likely to provide better services and give stronger voice to smaller countries.

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 multiply the creation of multilateral development banks owned by developing countries, and by investing in the capital and bonds issued by such institutions. A network of multilateral development banks is already in place, though unevenly developed in different regions of the developing world. The multiplication and growth of these institutions is fertile ground for South-South cooperation.

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