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International financial architecture seen through the lense of economic crisis: achievements and numerous challenges

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0. Introducción [*]

This paper looks at the process of international financial and monetary reform from the moment of the crisis in Asia until the start of 2010 in terms of the basic objectives which international financial architecture should meet. Those objectives are essentially the following: (i) to regulate the financial and capital markets in all countries, as well as cross-border transactions, in order to avoid the excessive risk accumulation which has caused frequent, costly crises, both in developing as well as in developed countries; (ii) to offer emergency financing during crises, especially to ensure liquidity, complementing the functions of the central banks which act as lenders of last resort at a national level; (iii) to provide adequate mechanisms at an international level to manage problems of excessive leverage; to guarantee the consistency of national economic policies with the stability of the world economy system, and to avoid the macroeconomic policies of some countries having adverse effects on others; and (v) to guarantee an international monetary system which contributes to the stability of the international economy and is seen as fair by all parties. The Monterrey Consensus, approved by the United Nations International Conference on Financing for Development, which took place in 2002, might come closest to the definition of those goals although it does not include any of them explicitly (especially not the last one).

While some of those objectives refer to crisis prevention, others relate to the handling of crises once they have started. Nevertheless, such a division is not a straightforward one since some good instruments for handling crises also have preventive effects as the history of the central banks throughout the world shows. Nor is the distinction between micro and macroeconomic matters clear-cut since, as we shall see, financial regulation should include an important element of macroeconomic protection.

This paper is divided into four parts. Given the importance of the debate under way on financial regulation as a central mechanism to prevent crisis, the first section tackles this theme as well as corresponding questions on institutional arrangements. The last section of that part analyses a question which is partially interrelated to the previous ones which has emerged strongly in recent debates: the role of an international tax on some financial transactions. The second part considers some of the main problems concerned with the prevention and tackling of crisis in the developing world. That part concentrates, therefore, on the second and third objectives and the way in which developing countries have responded to the flaws in international financial architecture; this section will also look at a closely related question of the increasing demand by developing countries to participate in international financial organisations. The third part analyses the fourth and fifth objectives mentioned which, as we will see, are related. After briefly considering some of the problems associated

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with how to guarantee the consistency of national macroeconomic policies, we look more closely at reform of the international monetary system and propose a reform based on a significant expansion by the IMF (International Monetary Fund) of the use of Special Drawing Rights (SDRs). To conclude, the last part presents an overview of the reform of the international financial system since the Asian crisis; here we also study some of the characteristics of global economic governance.

It is worth highlighting that the paper focuses on monetary and financial architecture and leaves aside, therefore, recent events on matters of financing for development, which also show a clearly complicated panorama, but where some positive developments stand out: the clear recovery of the official development aid after the Monterrey Conference and the aggressive response of multilateral development banks to provide financing during the recent crisis. It is nevertheless possible that the global crisis has constrained the first of those processes, but there are no total figures out yet which could corroborate that.

1. Deficit and the governance of financial regulation

1. THE REGULATORY DEFICIT

The seriousness of the global financial crisis laid bare the magnitude of the regulatory deficit that existed. This problem was particularly acute in developed countries since many developing countries had responded to the series of financial crises they faced from the 1980s by strengthening their regulatory and supervisory frameworks. This regulatory deficit has two different dimensions. One the one hand, although the banking system was regulated, the regulation was insufficient in key areas and enforcement was not adequate due to deficiencies in the supervisory systems. On the other hand, there were significant areas of financial activity and financial agents (the so-called “shadow banking system”) that lacked any form of regulation.

The main effort made at an international level before the crisis was the negotiation of the Basel Agreement on banking regulation (Basel II). Although this agreement has various positive elements, it also contained a series of important flaws. One of its most worrying features, highlighted by a few commentators in the early 21st century (Griffith-Jones, Segoviano and Spratt 2002; Goodhart 2002), and clearly recognised after the global crisis was the fact that it reinforces the naturally cyclical behaviour of bank loans. In fact, the main failure of the financial markets is the tendency, both of lenders and borrowers, to assume excessive risks during boom periods. Those risks lead to significant losses later, when growth slows, in bank portfolios and other losses, and that can set off financial crises. Basel II exacerbated this pro-cyclical behaviour by giving increasing weight to the risk evaluation models of the banks themselves in the determination of suitable capital levels, which reproduces the inherent pro-cyclical pattern in the behaviour of banks.

The need to introduce specific anti-cyclical mechanisms in banking regulation had been recognised by some analysts since the end of the 1990s, especially by the United Nations and the Bank for International Settlements (Ocampo, 2003; Griffith-Jones and Ocampo, 2009). In this field, one of the most important innovations was the Spanish system of anticyclical banking provisions, initially introduced in 2000. However, neither those analyses nor the Spanish practice received adequate attention and were ignored by Basel II.

Another problem of Basel II was that it overestimated the risk of bank loans made to developing countries, overlooking the fact the benefits of diversifying the international portfolio in terms of risk reduction. As a result of this flaw, Basel II can result in excessive capital requirements for loans to developing countries, reducing those loans and/or increasing their costs. It would be an extremely good idea if Basel II incorporated a factor into it which took account of the benefits of diversification as it did for loans to small and medium-sized companies (Griffith-Jones, Segoviano and Spratt, 2002).

The areas which lack regulation include, firstly, off-balance sheet bank transactions, which have in fact been one of the most important sources by which the global crisis in the mortgage bond markets and other wrongly highly rated assets spread to the banks. In the same way, problem loans at some banks spread to other agents in the financial markets. The problems inherent in rating assets by rating agencies have also been the subject of a lot of attention in recent debates, above all the tendency to poorly evaluate the risk of loans which are not going to be kept on a bank's own books but which are to be sold off. Those loans heavily contributed to the crisis.

Another area with poor regulation is the derivatives market and the alternative investment funds (generally called *hedge funds* in the Anglo Saxon world, although their operations go beyond hedging operations), which are particularly active in derivatives markets. Given the multiple flaws which characterise those markets (which fall far short and are very imperfect, particularly during crises), it is crucial to improve regulation here.[1] Lastly, the lack of regulation of the ratings agencies has also been the subject of a great deal of debate, as well as the possible conflicts of interest between their rating business and their business advising agents which are active in the market (Goodhart, 2010).

One of the most important breakthroughs in the international debate of the last two years has been the recognition that the international financial crisis was clearly associated with inadequate, insufficient supervision of financial activities. This is precisely the sphere in which the G-20 has played a role, especially in reaching agreement on certain principles, the implementation of which, nevertheless, remains the subject of debate and on which slow progress is being made in the United States and Europe, as well as in international regulatory organisations. The Basel Committee on Banking Supervision (which we will refer to from now on as the Basel Committee) had already started to discuss among its members some practices as a complement to the regulations that Basel II introduced (Basel Committee 2009a and 2009b).

The Basel Committee's proposals, which will be refined in July 2010 and approved in November 2010, put forward significant increases in capital requirements, especially for Tier 1, as well as a stricter definition of that capital, both designed to strengthen the solvency of banks. The proposals would also imply increasing capital for bank operations in the capital markets (the "*trading book*") and the introduction of anticyclical provisions, an issue that we will address in greater detail later. Finally, the proposals make liquidity requirements stricter and more explicit and they propose a new maximum leverage limit to restrict banks' total assets as a proportion of their Tier 1 capital. At the time of writing this paper, it is still not totally clear either the scale of the measures, or the speed with which they will be approved, since there are some differences of opinion between the member countries of the Basel Committee as well as serious lobbying from the banks to limit the increases in capital requirements; that said, the head of the Basel Committee has stated the clear commitment of the Committee to adopt significant reforms to strengthen banks.

These national and international proposals have followed two basic principles that are worth analysing in detail: those that guarantee a comprehensive, as well as a countercyclical

1 Look at the collected essays on this in the recent book by Griffith-Jones et al. (2010).

regulation. But they have also tackled other matters, among them consumer protection and the need to down size excessively large financial institutions.

The first principle mentioned is that regulation should be comprehensive, or that it should at least have a broad scope in terms of instruments, institutions and markets (D'Arista and Griffith-Jones, 2010), in order to avoid, as we highlighted, serious avoidance of regulation through non-banking intermediaries (or barely regulated banking intermediaries), which contributed to the crisis. Moreover, that should be accompanied by an increase in the capital base, that should also be better quality, consistent, transparent and cover all the risks which financial institutions face (including those associated with securitisation, investment in shares, bonds and other securities which form part of the "*trading book*", and the counterparty risk associated with derivative operations and the financing of operations in the capital market), as recognised in the Basel Committee proposals mentioned. For many analysts an essential element is the obligation for all markets to be open and transparent and, therefore, to limit over the counter trades. The initiative of some US legislators (which has still to be approved) to oblige all standard derivatives to pass through clearing houses would be a positive step to improve transparency and reduce counterparty risk and it should be applied to all derivative transactions. We can expect European regulation to follow these US reforms on transparency in the derivatives markets. In the case of alternative investment funds, especially for hedge funds, it is the European Union that has taken initiatives to improve transparency by requiring their registration, as well as proposing some precautionary regulatory measures; however, those proposals have now been approved in spite of opposition from financial players and the reservations of some countries.

It has also been recognised that financial intermediaries that are systemically important should be subject to particularly rigorous supervision, and even to stricter regulatory norms, and that the methods of compensation of executives in the financial sector should be subject to regulation. The first question has been particularly focused on in the Unitedd States where the Treasury Department announced in 2009 that capital requirements of large financial intermediaries would be proportionally higher. In 2010, President Obama went further and announced limits on the size of banks. Since 1994, there are limits on the ratio of total deposits (10%) that can be held by one bank; the new rule would also apply to other liabilities. Another important proposal announced by President Obama would ban the use of bank resources in their own trading (so-called "proprietary trading"). That rule would also affect a group of large financial institutions, which trade on a large scale using their own resources and those of depositors.

The Financial Stability Board has welcomed this initiative but has highlighted that this is just one of various options designed to tackle the issue of organisations being too large to be allowed to go bankrupt ("*too big to fail*"). Those options include, for instance, capital, leverage and liquidity requirements being based on size and the complexity of the structures of financial conglomerates.

The question of regulating the bonuses of executives and traders at financial companies has similarly ignited heated national and international debate. The key problem has been not only that the salaries are excessive but also that they are structured in such a way that they incentivise highly profitable short-term activities which are excessively risky in the medium-term, which implies risks both for the individual financial institution as well as for the

financial system as a whole. Those bonuses are also asymetric since they are high when short-term profits are high but never negative (and even continue to be high) when there are large losses. The Financial Stability Board has stated its intention to raise the capital requirements of institutions that have bonus systems that increase future risk. Several countries have taken partial measures in this respect although they are insufficient.

The second principle which we have highlighted, and which represents an important step forward in recent discussions, has been the recognition that safeguards should have a clear countercyclical focus. The crisis generated, in fact, a large consensus on the need to adopt counter cyclical regulations both at the G-20 level (2009a and 2009b) as well as in diverse international reports on regulatory matters (the Untied Nations, 2009 and the Warwick Commission, 2009, for instance). As a result of this, the Basel Committee included some suggestions in this area in its December 2009 proposals (Basel Commission, 2009b). There is, moreover, a growing consensus that it is not sufficient to reduce the procyclical nature of existing regulation (Basel II); it is also essential to curb the natural tendency of banks and financial markets to generate huge booms, which result unsustainable in the end and which therefore result in heavy falls and even collapsing markets.

The most important rules would be those to oblige financial institutions to accumulate more capital (or non-distributable reserves) and/or provisions for debts that are unlikely to be collected, or provisions to be set aside in boom periods to increase the capacity of financial institutions to act during crises. One alternative, the one introduced by the Spanish system, would be to make the provisions when the loans are made, based on the expected losses ("potential losses"), estimated on the basis of a complete economic cycle. The advantage of this system is that it allows provisions to be accumulated against losses during the phases of rapid expansion of credit, giving a "rainy day provision" to absorb losses during crises which can also contribute to putting a curb on the credit boom – although that did not happen in the Spanish case (Saurina, 2009). There is, moreover, some agreement on the need to set absolute limits on leverage (the relationship between the value of total assets and the capital of institutions). Some analysts have even proposed direct restrictions on credit growth during boom times. Accounting rules, as well as capital and provision requirements, should also take into account the nature of the financing which financial institutions use (short-term versus long-term, as the Warwick Commission highlights, 2009.)

Another equally important element to countercyclical regulation are rules to avoid the heavily procyclical behaviour of financial asset and real estate prices multiplying during the booms through an artificially high value being attached to the credit guarantees. The rules should therefore restrict the value of the guarantees accepted during the periods of inflation of asset, make additional provisions obligatory for credits guarantees for assets that have rapidly increased their value, or increase the capital requirements in those cases. Any system of this type would have avoided or softened the highly costly crisis in low quality mortgages in the United States, and also in European countries like Spain, Great Britain and Ireland.

In the case of developing countries, the problems of currency mismatches are also very important, especially due to the tendency of exchange rates to appreciate during booms and to depreciate during crises. In the absence of appropriate anticyclical norms – or better still of restrictions or bans on those exposures – the risks assumed during the booms tend to be reflected in large capital losses during crises, as developing countries learnt during various

crises – and as various countries in central and eastern Europe learnt during the most recent one.

Among the debates that co-exist in this field, an important one is related to the decision whether to opt for rules or to issue norms in a discretional way during periods of economic growth. There seems to be a global preference for pre-established rules, which would reduce the risk of regulatory interference, whether by financial interests or through excessive enthusiasm which characterises economic authorities during boom periods. Rules could be made stricter, but never looser during boom periods. Appropriate indicators (such as credit growth and/or asset prices) need to be chosen in order to ensure that the countercyclical capital set aside corresponds effectively to the cycle.

One matter which has received relatively less attention in the field of anticyclical regulations is that of liquidity, leaving aside the Basel Committee proposals on the banks, which we have already mentioned, which are in any case limited. Since solvency and liquidity are complementary, there might be arguments to have joint requirements on them, which would involve requiring institutions with large imbalances in maturity periods to hold more capital. However, since the capital would never be sufficient to cope with serious liquidity problems, there is a clear justification for setting specific requirements on liquidity based on, for instance, the residual maturity of the obligations of financial institutions.

Accounting rules have also been a subject of much debate. They should satisfy both the need for transparency as well as for financial stability. One interesting alternative which has been suggested is for two accounting states to be estimated: one in which current earnings and losses are reported, according to valuations or market prices, and another in which future provisions are deducted from current earnings or for a non-distributable "economic cycle fund" to be established, which could only be used to cover losses in the future.

In order to avoid regulatory arbitrage, it is important for anticyclical regulation to be applied to all institutions, instruments and markets, and both nationally as well as internationally. However, since economic cycles do not completely coincide, the regulations should be applied by the host countries, although in accordance with internationally agreed principles. One area in which coordination is essential has to do with contagion. A crisis in an important country (especially if it is an important creditor, debtor or trade partner) can seriously affect the financial stability or the economy of other countries even if those countries did not accumulate any systemic risk. Therefore, in a globalised economy all countries have a legitimate interest in avoiding procyclical excess in other countries.

Two matters connected to the comprehensive and anticyclical nature of the regulations are related to the best moment to introduce the new norms and to the effect on access to credit. In terms of when, it is clear that it is important to agree regulation during crises when the political appetite for regulatory reforms is high and new rules also help to restore the confidence of the financial system. Increasing the scope of regulation should also be immediately applied. However, those rules involving more capital, provisions and liquidity should be gradually introduced and only fully implemented after the economy recovers and the financial institutions have returned to strength.

It should be noted that the banks have started to resist an increase in capital requirements as well as its anticyclical nature with the argument that they would reduce the total level of credit and ultimately economic growth. This argument reinforces the importance of gradually introducing the regulations but is not an argument for not pursuing regulatory reform. The fundamental argument for reform is that higher regulatory and anticyclical requirements would help to create a much more stable banking system, which would have a positive impact on long-term growth.

In terms of access to credit, it is worth highlighting that stronger regulations should result in higher spreads, as well as excluding those agents from credit that are considered particularly risky. That could generate less financing for small and medium-sized companies or for poorer households. Therefore, it might be necessary to introduce additional instruments to guarantee access to credit. Higher margins could also mean companies with direct access to international credit markets could have an incentive to seek loans abroad, increasing the probability of currency exposure in the portfolios of those agents. This is why it is particularly important to introduce rules aimed at handling currency mismatches, as mentioned previously.

Among the other issues worth highlighting in the process of strengthening regulation is the issue of consumer protection, which has been particularly important in the US debates. Due to the quality of toxic mortgages and high-risk investment vehicles, which were being offered in recent years to homes that were not financially sophisticated, consumer protection needs to be strengthened, as well as the principle that financial instruments should be as simple as possible since complexity leads to information problems and difficulties for the markets in valuing the corresponding instruments.

It is also probable that the crisis under way ends by generating a larger market share for some companies in the financial industry. That means restrictions on monopolies and even the possibility of dividing up the largest institutions should also figure in the new regulations. That includes differential treatment to the largest institutions, mentioned earlier. Lastly, and very importantly, it is essential for safeguards to be applied with rigour and for supervision to be carried out to the highest standards. Some of the most serious errors that led to the current crisis were the result of a lack of supervisions and strict application of the current norms.

2. THE GOVERNANCE OF INTERNATIONAL FINANCIAL REGULATION.

Despite their growing importance, due to the integration of financial markets, global regulatory Institutions have been – and continue to be perceived as – undemocratic and of limited effectiveness. One central problem here is the representation of developing countries, as the Monterrey Consensus has highlighted, as well as various academics and non-governmental organisations across the world, and of course, the developing countries themselves. Nevertheless, while the Bank for International Settlements has selectively increased its members,[2] institutions like the Financial Stability Forum (FSF) and the Basel

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2 It also included the Presidents of the Central Banks of developing countries (Mexico and China) in their Directory. Moreover, at the moment the President of the Directory of the International Settlements Bank is the President of the Central Bank of Mexico.

Committee continued to exclude developing countries. An exception to this rule was the International Organization of Securities Commissions (IOSCO), the stock exchanges regulator, which had a wide representation from developing countries. However, its Technical Committee – which generates any regulatory initiatives – only had OECD countries as members.

Given its importance and authority in establishing international banking standards, the Basel Committee has been the target of most criticism. The exclusion of developing countries from the Committee has doubtlessly distorted and biased the policies designed, which proved ineffective in guaranteeing financial stability and were biased against the interests of the developing world (Griffith-Jones and Persaud, 2008). However, despite all this criticism, it was not until the global crisis and the subsequent declaration by the G-20 in November 2008 that some significant changes to the governance of the international regulatory institutions were made.

As is obvious, representation of different members in the governance of an institution is translated into decision-making. That has been extremely well-discussed in the case of the IMF in which voting rights on the Managing Board influence significantlly in the decisions of that institution (Rustomjee, 2004; Woods and Lombardi, 2006). A similar effect is observed in regulatory organisations whose support of global financial stability proved less effective due to their very biased governance structures.

If changes had been introduced to the country representations that make up the regulatory organisations, the very concentrated interests of the large private financial players could have been diluted. Many of the approaches, assumed and promoted by the large banks, such as use of risk models, reflected a confidence in the large banks being able to measure risk parameters themselves. Various developing countries were sceptical about the viability and effectiveness of those approaches, and they were worried about the procyclical dimensions of the regulation developed. Developing countries had experienced a series of financial crises in the immediate past and, being more aware of their costs, gave greater priority to preventing crises. Their lack of participation in the Basel Committee could have, therefore, biased decisions in favour of the large international banks and against crisis prevention.

Table 1: The composition of membership of regulatory organisations
Members per country in July 2009 (N: new countries since September 2008; members prior to September 2008)

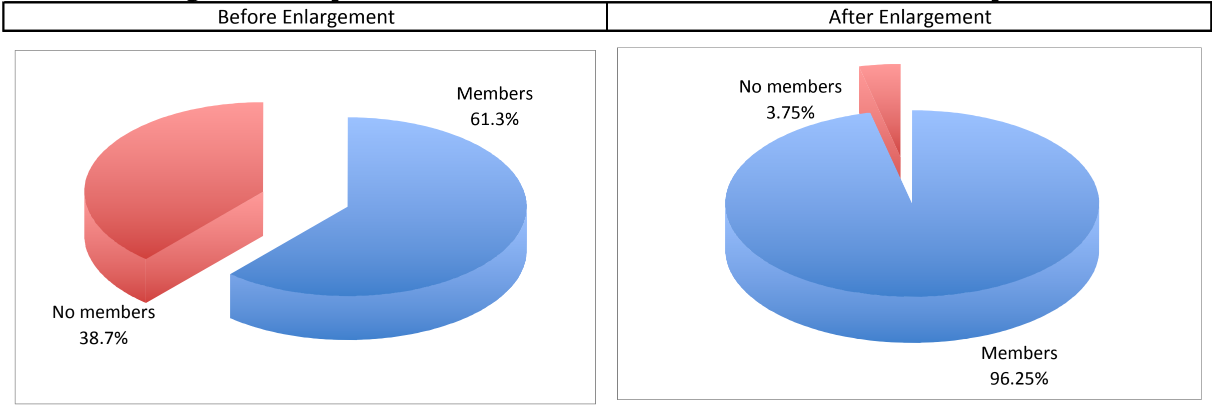
	DEF	Basilea Commettee	OICV (Technical Commette)	CSPL
Argentina	N (1)	N		
Australia	A (2)	N	A	N
Belgium		A		A
Brazil	N (3)	N	N	N
Canada	A (3)	A	A (2)	A
China	N (3)	N	N	N
France	A (3)	A	A	A
Germany	A (3)	A	A	A
Hong Kong	A (1)	N	A	A
India	N (3)	N	N	N
Indonesia	N (1)	N		
Italy	A (3)	A	A	A
Japan	A (3)	A	A	A
Luxemburg		A		
Mexico	N (2)	N	A	N
Netherlands	A (2)	A	A	A
Rusia	N (3)	N		N
Saudi Arabia	N (1)	N		N
Singapur	A (1)	N		A
South Africa	N (1)	N		N
South Korea	N (2)	N		N
Spain	N (2)	A	A	
Sweden		A		A
Switzerland	A (2)	A	A	A
Turkey	N (1)	N		
Great Britain	A (3)	A	A	A
USA	A (3)	A	A(2)	A

Note: The numbers in brackets show the number of members per country.
Source: Helleiner and Pagliari (2009)

In the midst of the global financial crisis and driven, as we have seen, by the decision of the G-20 of November 2008, an important number of those institutions widened their membership, particularly to include so-called emerging economies. Table 1 summarizes the changes to the regulatory organisations. In early 2009, the Technical Committee of the International Organization of Securities Commissions, which apart from Mexico had not previously included any other developing country among its members, included among its members Brazil, China and India. In March 2009, the Basel Committee included for the first time various developing countries (Brazil, China, the Republic of Korea, India and Mexico), as well as Australia and Russia. In July 2009, it widened its membership still further, including all the G-20 countries which were not already members (Argentina, Indonesia,

Saudi Arabia, South Africa and Turkey) as well as Hong Kong and Singapore. As Graphic 1 shows, that closed a large gap in the degree of representativeness of the Basel Committee, in relation to the countries that supervised the 50 largest banks in the world. However, countries with relatively small banks are not adequately represented which means banking regulation continues to excessively meet the interests of the large banks in the main industrialised countries. At the same time, the Committee on Payment and Settlement Systems (CPSS) invited the following members: Australia, Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa and the Republic of Korea. This is another organisation based in Basel which serves as a forum to the Central Banks to monitor national payment systems as well as cross-border and multiple-currency agreements.

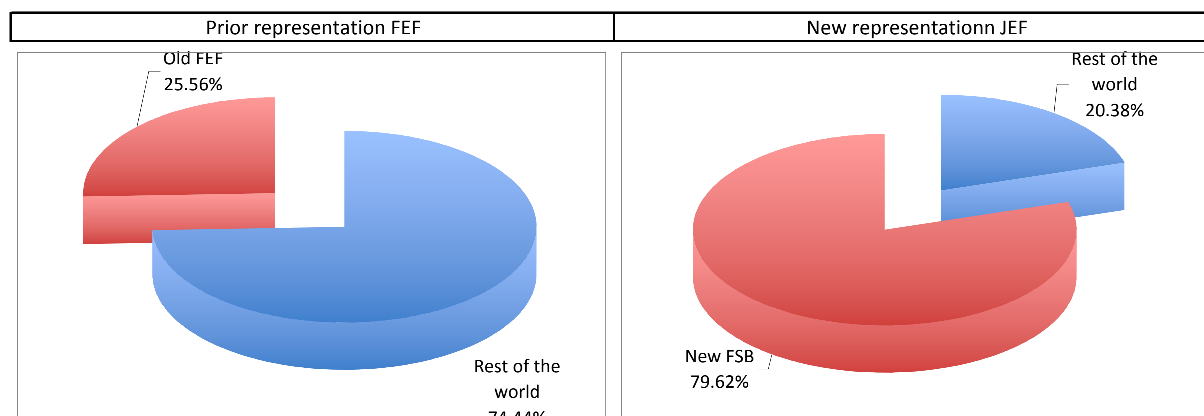
Graphic 1: Percentage of the 50 largest banks in the world (by market capitalisation) with regulators represented on the Basel Committee, March and April 2009.



Source. Griffith-Jones and Young (2009)

In the second quarter of 2009, the Financial Stability Forum increased its number of members to include all the members of the G-20, which includes most large developing countries as well as Spain and the European Commission. It was given the new name Financial Stability Board (FSB) to reflect its additional powers. This enlargement to the membership was also significant; as Graphic 2 shows, if measured in terms of world reserve distribution, the FSB has a much better representation than its predecessor.

Graphic 2: Representation of the Financial Stability Forum/Board (FSF/FSB) measured by World Reserves



Fuente: Griffith-Jones y Young (2009)

This increase in the participation of developing countries in the FSB is, of course, a positive step. However, it throws up two problems. The first is to do with the number of representatives of different countries. With enlargement, three different categories of countries were created: the BRIC (Brazil, China, India, Russia) joined the G-7 group of countries, with three representatives each, while Australia, Mexico, the Netherlands, Spain, the Republic of Korea and Switzerland assigned two and the rest given one (Argentina, Hong Kong, Indonesia, Singapore, Saudi Arabia, South Africa and Turkey). Therefore, (with the exception of the BRICs), the emerging economies represented in the FSB have one or two representatives while the G-7 have three, and even worse, the poorest economies and the small and medium-sized countries do not have any representation.

The second problem is to do with the fact that the FSB is now not only structured around a plenary session but also around a Committee for Initiatives and three additional committees. While this enlargement and specialisation is welcome since it strengthens its role, it is striking that all the heads of those five bodies come from developed countries. A greater diversity would be desirable in the future. One interesting example, which could be imitated, is that of the four working groups set up by the G-20 between November 2008 and April 2009. Each working group was headed by one developed country and another from a developing country.

This is the root of some of the additional reforms that need to be introduced. We will underline three here. The first is the inclusion of representatives of small and medium-sized countries on the regulatory bodies. That would ensure that their concerns would be listened to – for instance, the preference for simpler regulation, as well as for small and medium-sized countries having greater regulatory powers to regulate the large international banks which are active in their countries (see the Warwick Commission, 2009, on this respect). That could also lead to regulation reflecting the interests and preferences of the largest international banks to a lesser degree and regulation would be more appropriate for regulate smaller, nationally focused banks. One alternative would be to establish *regional* representatives instead of individual nations on regulatory organisations (with perhaps just a few exceptions such as some important countries). Those representatives could be chosen by the countries of each region according to votes (as occurs in the IMF and the multilateral banks) and with some

rules on rotation to guarantee that small and medium-sized countries are represented. The model of representation used by the IASB could be useful here. (see footnote 2). A system of regional representation would also have the advantage that all the countries would have at least one indirect representative. This fact, as well as the representation of small and medium-sized countries would also have the advantage of increasing the legitimacy and efficiency of those organisations. Introducing such changes soon is, moreover, urgent in order to avoid the new structures becoming antiquated.

Secondly, it is important to include better systems of holding regulatory organisations to account, through national parliaments in the case of national regulators, to which in the future international regulatory organisations and multilateral representative institutions should be added (United Nations 2009).

Finally, the benefits of including developing countries in key international regulatory organisations could be reinforced by the creation of a Technical Secretariat to support them in their interactions with those organisations. This Secretariat could prepare, or be in charge of studies, provide a forum for debate between developing countries and help – when appropriate – to define the positions of those countries, especially those which require international action and/or that of developed countries. One example is the possible international regulation of the "*carry trade*" which could have procyclical effects, which is a subject of particular interest to developing countries. In this process the main group of developing countries could play a particular role for the G-24 in areas related to the Monetary Fund and the World Bank.

3. REGULATORY FRAGMENTATION: TOWARDS A GLOBAL FINANCIAL REGULATOR?

International prudential regulation has developed in a weak and fragmented international context. But finance is globally integrated and, therefore, there is an imbalance between the global growth of the financial sector and the international regulatory structure. In the past, regulation and financial supervision have been fundamentally national. The majority of regulatory financial agreements simply acquired the form of standard "Best practices" and "Principles" which were not legally binding. Developing countries often found themselves obliged to follow those standards either because it was a condition of the IMF or World Bank rules, or because the financial markets pressurised them indirectly to do so. That is improper.

The need to expand the world's regulatory spaces is in keeping with the principle that for regulation to be efficient the regulator's domain should be the same as the market that it is regulating. Important parts of the markets and financial institutions are global; consequently, the regulation should also be global. Moreover, financial activity and risk taking will quickly grow in areas where there are gaps in the regulation or where those gaps give way to regulatory arbitrage.

A global financial regulator would design standards to be applied to all countries and jurisdictions and it would adopt supervision mechanisms to guarantee their application. This is why it is particularly important for the regulator to have real power over those countries

whose financial systems have an impact on the global system. Nevertheless, the regulator should allow regulation to be adapted to the different conditions of each country, operating, therefore, as a *network* of national regulators with strong international coordination. That would follow the principle that global regulation be based on good national regulation (Stiglitz, 2010). For example, the criterion of anticyclical regulation could be internationally agreed; nevertheless, as has been highlighted, its instruments would work at a national level in relation with the state of the cycle in each country. That is one of the reasons why, as the United Nations (2009) and Brunnermeier *et al*. (2009) argue, it is better for international bank subsidiaries to be subject to the regulation of the country where they are based. Additionally, national financial institutions without global connections would continue to be nationally regulated (Reddy, 2010).

Given the difficulty of reaching a consensus for the creation of new international institutions it would be a good idea to adapt one or more of the existing ones. One suitable one which could be adapted would be the Bank for International Settlements (BIS) given its interest in the systemic risk in financial markets and the need to regulate them, the high quality of its analysis and its close ties to central banks and regulatory entities. Nevertheless, a prerequisite for this institution being transformed into a global financial authority would be a considerable enlargement of the membership to make it a global institution. It would also be essential for the Financial Stability Board, to which the BIS contributes a Secretariat, to be a central part of the global regulator.

Additionally, there should be a close process of consultation with the IMF on elements of macroeconomic risks, both at a global level as well as at the level of each country. There is, however, agreement that the IMF is not the appropriate financial institution to assume the challenge of global regulator. For reasons of macroeconomic stability, countries will be allowed to divide their markets with regulations on cross-border capital flows, as the Articles of Agreement of the Fund set out. The regulation of those capital flows could be a good idea, especially if the financial regulation is seen as insufficient to reduce the volatility of capital flows.

It is important to ensure that the new global regulator is not just effective and efficient but also representative. That is why it is important for developing countries to be adequately represented, in accordance with the criteria outlined in the previous section.

One reason why governments, both in developed as well as developing countries, resist the creation of a global regulator is that they do not wish to relinquish national sovereignty in the field of financial regulation. However, this perception is misguided since the globalisation of private finance means that national authorities already no longer have full control over the conditions that determine the financial stability of their respective countries. That is why instead of giving up their sovereignty, efforts to coordinate between countries through a global regulator should be understood as an exercise in shared sovereignty, which will allow countries to increase their joint control over the global financial markets.

4. PROPOSALS FOR A TAX ON FINANCIAL TRANSACTIONS

For some time there have been various proposals for "innovative sources of financing" that would allow both the United Nations' official aid for development target to be met (0.7% of gross national income for industrialised countries) as well as the provision of global public goods. This matter has been explored in academic terms (see, among others, the essays collected in Atkinson, 2005) and has received repeated support in different United Nations summits since 2000, including the Monterrey Summit. The greatest advance in the corresponding international debates was achieved at the World Leaders' Summit on Action against Hunger and Poverty, which took place at the United Nations in 2004, which highlighted the advantages of predictability and potential stability of such innovative flows.

Some of those innovative flows have begun to be adopted by some countries, in particular in the form of special taxes on air tickets and the emission of bonds backed by cash flow expected from official aid for development (the so-called international finance facility), which allows advance payment on the paying of such resources. In both cases, such resources have been used to finance international initiatives in the field of public health. Studies already completed show, however, that the greatest flows come from taxes on carbon emissions and those on financial transactions. This last one merits some attention in this paper because of its relationship to the matters we are discussing.

The financial crisis has awakened a strong increase in interest in taxes on financial transactions, which have received recent support not just from civil society but also from the government of various industrialised countries. This proposal has recently received the support of the former Prime Minister and the head of financial regulation in Great Britain, the country with the largest financial centre in the world in currency trading. Similarly, the leaders of France and Germany have given important backing to such an idea, which has also won strong support from other European countries such as Spain, Norway and Belgium, as well as Japan, and the President of the Congress of US representatives.

There are various important reasons for such strong support for a tax on financial transactions. Firstly, even a small tax (of 0.005%) applied exclusively to large currency transactions in the main currencies could generate a significant sum: more than US$30 billion a year (see Schmidt, 2008, and Spratt, 2006, on this). Those resources are critical at a moment in which the global crisis has caused a significant rise in deficits and levels of public debt in developed countries, which has reduced the possibility of attaining the goals on official aid for development just as the crisis has also increased poverty in many developing countries, making it difficult to reach the Millennium development goals. Moreover, governments all over the world need additional resources to fund investment in developing countries to fight climate change at the same time that the global crisis makes it less probable that the private sector will fund such investment. The fact that a high proportion of large currency trades are carried out by high-earning individuals or specialised financial agents, including alternative investment funds, also make the imposition of a tax on those transactions attractive.

The second reason why the idea of charging taxes on financial transactions is becoming increasingly attractive, particularly on currency transactions, is that the charge would be facilitated by the large centralisation and automation of the clearing houses. The use of those

systems would reduce collection costs and also reduce the risk of significant evasion of the tax.

Thirdly, political backing for such a tax is greater than before given the perception that the behaviour of the financial sector was one of the main causes of the current crisis. As a small tax, the amounts charged would not affect the functioning of the currency markets nor significantly reduce the volume of their business.

There is also a large tradition of applying taxes to financial transactions at a national level, including in Great Britain (the very effective stamp duty on all share sales of 0.5%, in other words 100 times more than the tax proposed above to currency trades). Stamp duties on mortgage deals and some other financial deals are also normal in a lot of countries such as the United States. In Latin America, various countries have for several years set taxes on internal financial transactions and sometimes on external ones; Brazil is the one that stands out most. Some commentators have, moreover, said that the fact that the currency markets are tax free despite their high volume is a real anomaly, which should be corrected (Spraat, 2006). Capital income reserves, applied at different times by Spain, Chile and Colombia, have similar effects (and, in fact, in some cases might be substituted by a payment for the equivalent cost of opportunity) and Malaysia introduced a tax on capital being taken out of the country during the Asian crisis.

It is worth highlighting that the proposal to tax financial deals has a long and distinguished theoretical tradition. The need to correct the difference generated by negative externalities between the marginal public and private profits of a determined economic activity, by means of taxation, has been recognised at least since Pigou (1920). John Maynard Keynes, in *The General Theory of Employment, Interest and Money,* proposed more specifically a small tax on financial transactions, especially on the stock exchanges, in order to mitigate the volatility generated by the speculative excesses of some market agents (Keynes, 1936). The US Nobel prize-winning economist James Tobin proposed along the same lines in 1972 a tax of 1% on currency transactions. In 1996, however, he said such a tax should be considerably lower, at maybe 0.1%. As Tobin explained (1996), the proposal had two aims: make the exchange rates reflect fundamental long-term factors to a great extent, not just short-term expectations and risks, and make national macroeconomic policies more independent. Seeing that such a tax could increase significant resources, he suggested that they be used for international purposes. The "Tobin tax", as it has become known, was widely debated, especially after large financial crises, and was supported by economists of varying points of view (Jeffrey Frankel, Peter Kenen, Paul Krugman, Joseph Stiglitz, Lawrence Summers and John Williamson, among others). Recently, a new generation of theoretical models have sprung up based on the "microstructure" of markets (for example Shi and Xu, 2009), which can be characterises as "fundamentalist" agents, which tend to reduce volatility, and "noise traders" (speculators), which increase volatility. Those models, as well as others, tend to conclude that a tax, as long as it were small, would tend to reduce volatility in currency markets.

In recent years, though, the proposals to create a tax on currency transactions (*currency transaction tax*, or CTT) have varied compared to the initial suggestions of Tobin (see, for example, Landau, 2004; Nissanke, 2005; Spratt, 2006). In the context of the search for innovative sources for financing development, a very small international tax (of 0.005%) on currency transactions started to be suggested. The CTT differs, therefore, from that proposed

by Tobin, both in its goal, which now would be to raise additional resources and not to act as a disincentive to speculative flows as such, as well as in the sum proposed, which is much smaller, precisely to avoid distorting the currency market. The proposed tax now would be applied not only to spot market transactions but also to foreign exchange derivative trades whose important has risen significantly in recent decades. Given the high volume of currency transactions, estimated at around US$3 billion a day, it is estimated that a tax of this type could raise more than US$30 billion a year (Schmidt, 2008).

It is important to underscore that as a result of the bankruptcy of Herstatt Bank in 1974 and its negative effect on the international settlements system, the regulatory authorities, the central banks and private banks have taken a series of measures to reduce risk in the payment systems. That led to the establishment of the *Real Time Gross Settlements System* (RTGS) that aimed to eliminate the systemic risk in currency transactions. That means that all the transactions in foreign currencies are carried out in real time and in a centralised way. There is a series of institutions that support these activities, which are very centralised and have very full registers, such as SWIFT and the CLS bank. Together with the benefits of recent developments in technology, this makes it easy and inexpensive to charge taxes on currency transactions. Ideally, the tax would be introduced at a multilateral level (or, better still, applied to the main currencies), but various recent studies have shown that it could be applied to key individual currencies (detailed studies have been done on that on the euro and pound sterling).

It is worth highlighting that as a result of the global crisis, the authorities in the main financial centres are trying to increase transparency and the centralisation of all financial instruments and deals, including over-the-counter derivative deals or credit default swaps, among others. Once such measures are introduced, a small tax on financial transactions could be considered and used at least in part to finance development. However, that should be considered as a second stage. What could be immediately implemented is a small tax on currency transactions, to gain additional resources to fund development and with some desirable effects, albeit limited ones, on the volatility of the markets. This seems to be an idea whose time has come.

2. Prevention and management of crises in the developing world

1. THE MANAGEMENT OF PROBLEMS OF INDEBTEDNESS

Macroeconomic coordination, supervision of macroeconomic policies and financial regulation all share the fundamental goal of preventing crises. International financial architecture should also count on good mechanisms to deal with crises, in particular to avoid them starting in one country or one group of countries and spreading to others – the phenomenon which is now called "contagion".

One central problem of current international financial architecture in this field is the absence of a good mechanism to handle debt crises, similar to the bankruptcy regulation that exists in all national legislation. For more than half a century the Paris Club has been operating, which serves as a framework for debt renegotiation with the official organisations of the industrialised countries. The London Club was set up in 1976, which serves as an informal framework for the renegotiation of private bank credits.

Time and again, however, the main debt renegotiations have taken place outside those frameworks. That was the case with the negotiations between private banks and developing countries during the debt crisis of the 1980s, which was driven directly by the economic authorities in the United States, especially through the Baker and Brady plans of the mid to late eighties. The Brady plan proved a definitive solution, albeit a late one, to the crisis. In the case of public debts, the main renegotiation have taken the framework of the Heavily Indebted Poor Countries Initiatives, better known by its abbreviation HIPC, launched in 1996 and strengthened in 1999, and the subsequent Multilateral Debt Relief Initiative of 2005.

Those frameworks have two fundamental deficiencies. The first is that the restructuring initiatives have always arrived late when the debt problems have severely affected the countries, and indirectly also the creditors, which have been affected by the lower ability of their debtors to pay, due to their high level of indebtedness. The second deficiency is that the existing mechanisms do not guarantee equal treatment of different debtors nor of different creditors. In fact, a repeated criticism of the member countries of the Paris Club is that the private creditors do not accept the restructuring conditions agreed by the members of the Club and they benefit, by contrast, due to the lower burden which these processes impose on the them..

There is not, on the other hand, any multilateral framework for dealing with crises in the international bond markets. There have been numerous proposals since the 1970s to create international bankruptcy courts or forums for mediation or eventual arbitration. These initiatives proliferated after the Mexican crisis at the end of 1994 and, especially after the Asian crisis in 1997. The corresponding proposals have come from both sectors on the right politically, for whom the elimination of "moral risk" associated with final public guarantees

to private credits is an essential prerequisite for the good functioning of the financial markets, as well as from the left who see excess leverage as a clear obstacle to development.

The most important initiative was the one led by the IMF in 2001-2003, under the name Sovereign Debt Restructuring Mechanism (SDRM). This was rejected by both the United States, under clear pressure from its financial sector, as well as by various developing countries that feared that a mechanism of this nature would end up limiting or increasing their costs of accessing the international capital markets. There was also a clear opposition from some sectors to the IMF leading debt renegotiations given its clear conflict of interest (since it is also a creditor) and its rejection of the conditionality of its credits. This is why *ad hoc* negotiations continued to be the norm, initiated by indebted countries stopping servicing their debt, often in open confrontation with their creditors. The most notorious example in recent years is, of course, the renegotiation of Argentina's debt.

One of the main problems of all these mechanisms is that those parties that do not follow the terms of the agreements can go to the courts in the industrialised countries to defend their rights. An alternative solution to this problem was the rapid generalised use, between 2003-2005, of collective action clauses in the issuing of bonds in the United States, a mechanism that was already used in other markets, especially in the English market. This mechanism defines the majorities necessary to restructure a private bond issue. This alternative had been increasingly favoured since the Mexican crisis but it received its final impetus as a result of the search by the US government and financial sector to alternative solutions to the IMF initiative. As well as the collective action clauses, some "codes of conduct" were added, among those which stand out the "Principles for stable capital flows and fair debt restructuring in emergency markets" adopted in 2005 by the Institute of International Finance, a private organisation composed of large international banks.

Although it is still soon to judge if this route, a more decentralised and market-orientated route, is producing the desired effects, the need to count on a multilateral framework for debt resolution problems, which would be legally enforceable in the main financial markets, doubtlessly remains one of the main subjects that still needs to be addressed in the international financial architecture. An institution of this type would, moreover, also have the benefit that it would correct the two main flaws in the *ad hoc* structure which have arisen over time: it would allow restructurings that benefit both creditors as well as debtors (the essence of a good agreement in this field, in accordance with the relevant national legislation on bankruptcy) and it would give equal treatment to different debtors and creditors[3]. The recent United Nations Commission on monetary and international financial matters has put some alternative proposals on the table in this field (United Nations, 2009).

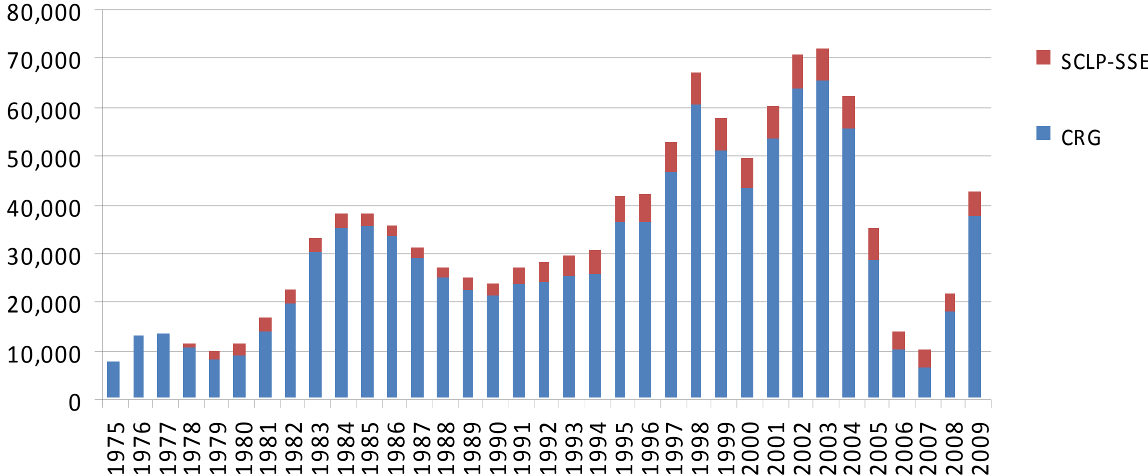
2. THE IMF'S EMERGENCY FINANCING

Despite the flaws highlighted, since the Second World War, the international community has been able to count on emergency financing from the IMF during balance of payment crises. As Graphic 3 shows, this mechanism provided increasing anticyclical financing until the start of this decade, especially during the debt crisis of the eighties and the succession of crises that

3 Read the extensive analysis on these topics in the essays collected in the recent book Herman et al. (2010).

began in 1994: Mexico, eastern Asia, Russia, South America and Turkey. One of its overriding characteristics was the tendency to concentrate financing on a few large debtors that were considered critical after 1994 in order to avoid the contagion of the financial crises and/or to avoid serious problems for the banks in developed countries (Mexico, Argentina and Russia; the Republic of Korea, Indonesia and Thailand; then Russia again; and Brazil, Argentina and Turkey, in this order chronologically). Following this pattern, the IMF increased its loans significantly in 2008, and especially in 2009, to countries affected by the global crisis. For the first time in a long time, the IMF included a high income country among its potential beneficiaries – Island – as well as emerging and low income countries.

Graphic 3: Use of FMI resources (Million of DEGs)



Note: SCLP-SSE, Service for growth and fight against poverty and service for exognous crashes, respectively (Line for the income of Netherlands) CRG, General resources account
Source: IMF (http://www.imf.org/external/np/fin/tad/extcred1.aspx)

After the Mexican crisis, the need to create new credit lines to mitigate balance of payment crises, caused by abrupt interruptions in external financing or capital being withdrawn, began to be recognised. This problem is exacerbated by the fact that the procyclical behaviour of capital flows to developing countries reduces the margin for adopting anticyclical macroeconomic policies and the conditionality of IMF credits tends to reinforce the procyclical behaviour of those policies. In fact, the absence of a multilateral framework aimed at supporting the adoption of anticyclical macroeconomic policies could be considered as the main deficiency of IMF actions in developing countries.

Here it is worth highlighting, however, that the IMF has been adopting a more flexible attitude on fiscal policies during the crises, as a result of the criticism it received during the

Asian crisis. In fact, in the face of the recessionary risks that the world economy faced, it has taken an openly anticyclical perspective on the economic policies that industrialised countries and, with greater caution, developing countries, should adopt.

In the context of the financial crises which the developing world faced after the Asian crisis, the IMF created two new credit facilities. The first, the Supplemental Reserve Facility, created in 1997, which served as a framework for the large loans made during the crises at the end of the twentieth century and the start of this century. The other, the Contingent Credit Line, had a more preventive aim. The last was never used because using it was perceived as an indicator of vulnerability, and it was suspended in 2003. In 2006 the IMF proposed an alternative line, called the Reserve Augmentation Line, which was under discussion for a long time. Although the proposal was positive in some respects, since it was automatic, doubts were raised about the prequalification process and the scale of the resources. For those reasons it was not used.

For the poorest countries, the structural adjustment lines created in the mid eighties were transformed in 1999 in to the Poverty Reduction and Growth Facility, in order to explicitly put the focus on poverty reduction. In January 2006, a credit line was added for those countries aimed at facilitating recovery after negative shocks – not just commercial ones but also natural disasters – and conflicts in neighbouring countries. Curiously, the creation of that line has coincided with a weakening of the traditional IMF loan, the Compensatory Finance Facility, which was designed to cope with negative commercial shocks (especially the deterioration in exchange conditions in middle-income countries). That facility languished due to its excessive conditions and was finally eliminated.

As well as the deficiencies in the credit lines, there was also another problem which has made the IMF the source of repeated criticism: the excessive conditionality of its programmes, which have historically included openly procyclical clauses on macroeconomic adjustment, structural conditions which many countries and analysts have considered antidemocratic because they are not based on decisions by representative national authorities, and the use of the IMF green light for macroeconomic programmes which accompany the official development aid (the "gatekeeper" function of those programmes, as it has often been called). The excessive conditionality, as well as the absence of credit lines to tackle a world characterised by a high mobility of highly procyclical capital, especially towards medium-income economies, and important fluctuations in exchange terms in poor countries, are some of the most serious problems which this organisation faced in designing its crisis management mechanisms when the financial turmoil of 2007 began.

Those problems were tackled, at least partially, as a result of the global crisis. In March 2009, the IMF created the Flexible Credit Line (FCL), which had preventative purposes, for countries with solid fundamentals but a risk of facing problems in their capital account. This line has been used by three countries (Colombia, Mexico and Poland), although it has not been drawn by any of them. The fact that it has not been used by other countries could indicate that it is not attractive and that perhaps the countries which have used it did it more as a show of support to the IMF decisions than out of necessity. Reflecting the discussions surrounding similar credit lines in the past, the additional problem of this line is that it artificially designs countries into groups, between those which have "good" policies and those which the IMF classifies as not having good policies, which can obviously increase the risks that the market perceives the second ones have. This classification implicitly transformed the IMF into a risk rating agency.

This is why the other reforms adopted in March 2009 were probably of greater importance. The first of them was to double the other credit lines and to allow a wider use of the ordinary Fund agreements (the stand-by agreements) for preventive purposes (the so-called "high-access precautionary arrangements". The second was to eliminate the relationship between payments and structural conditionality.

In terms of low income countries, the IMF made new announcements about its concessional credit lines (IMF, 2009d). Apart from doubling the credit limits, in accordance with the March reforms – which, although courageous, implies low levels of loans as a proportion of the external shocks in comparison with the emerging economies – it increased the global capacity of the loans to US$17 billion until 2014. The new Poverty Reduction and Growth Facility (PRGF), through which these initiatives are run, includes three facilities; (i) the Extended Credit Facility (ECF), which replaces the Poverty Reduction and Growth Facility (PRGF) and provides help to countries with difficulties in their balance of payments, and lasts various years; (ii) the stand-by lines, which can now be used for dealing with external shocks (which used to be addressed through a special credit line) and the precautionary needs of concessionary conditions; and (iii) a rapid credit facility for support during emergencies (like a natural disaster or a temporary external shock) with a limited conditionality, called the Rapid Credit Facility (RCF). The IMF also decided that all low-income countries would receive an exceptional cancellation of all owed interest payments until the end of 2011 on concessionary loan lines, as well as lower rates of interest on future loans.

In December 2009, the IMF reformed its concessional loan lines from a single design to a menu of options (IMF, 2009f). The menu aimed to be more flexible to different situations facing low-income countries in relation to their vulnerability to debt and their macroeconomic and public finance management capacity ("capacity" in the terminology of the agreement). Within this framework, each one of the two factors mentioned previously could take two values: one "inferior" or "superior". In this way, the framework determines four different concessionary options. Unless the sustainability of the debt is a serious worry (which would be a high value) and the capacity is limited, non-concessionary loans are allowed. On the other hand, countries where the vulnerabilities of the debt are relatively high will always be subject to concessionality.

In this framework, low "capacity" countries with a high vulnerability to the debt are subject to a minimum concessionary threshold of 35%, applied to each loan separately. In countries with lower vulnerabilities to the debt, the threshold is set at 35% and there is room for non-concessionary loans, based on the sustainability analysis of the debt. For countries with greater capacity which have a larger debt vulnerability, the annual limits would be set based on the average debt accumulation in terms of the present value. Lastly, for countries with the best position, those with greater capacity and lower debt vulnerabilities, a minimum concessionary average is set but that can be completely removed if it is considered appropriate.

Lastly, and in response to the criticisms associated with conditionality, the IMF programme for low-income countries is aimed at reinforcing the links between Fund supported programmes and the national Poverty Reduction Strategies (PRS), including the critical increase in social spending during the downturn by countries with low levels of debt sustainability. Nevertheless, the IMF still advises and requires member countries to reduce

discretionary expenditure aimed at temporarily supporting the economy and/pr to cut the fiscal deficit once the economy starts to recover (IMF, 2009e).

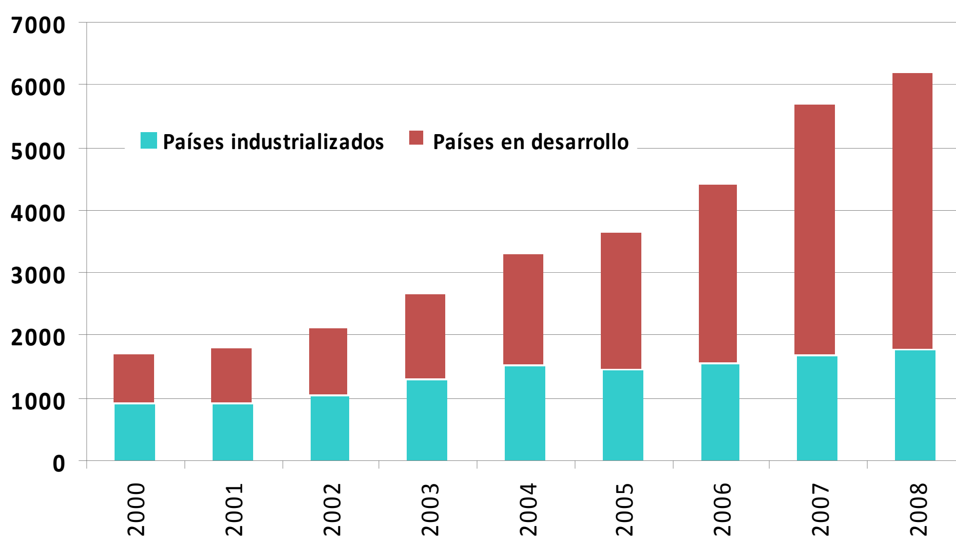
The history of the last decade indicates, therefore, that the international system demands the IMF to be more active as a last resort creditor and as guarantor of the stability of the international financial system, but also to be more dynamic in the awarding of emergency financing subject to lower levels of conditionality. The responses it has adopted during the crisis are an improvement but it needs to continue making progress on designing financing mechanisms with sufficient resources, that are automatic and which have a simple prequalification process to deal with the external shocks that developing countries face, especially those coming from the capital account, an issue which particularly affects medium-income countries, and the trade shocks that low-income countries face.

3. THE PREVENTIVE RESPONSES OF THE DEVELOPING WORLD

The two problems noting in IMF financing – excessive conditionality and the lack of appropriate credit lines – as well as the evidence that the risks implied by the procyclical nature of the capital movements which affect them, explain one of the most generalised approaches which the developing world has adopted in the last few years: a massive accumulation of international reserves. In contrast to the debt crisis resolution mechanisms and emergency financing of the IMF, this approach is preventive in nature and, in fact, decisively contributes to the lower vulnerability of these countries in the recent crisis.

The international reserves of developing countries multiplied by five between 2001 and the end of 2008, reaching 4.4 trillion dollars (Graphic 4). By contrast, industrialised countries did not face a similar pressure and the increase reflected in the graphic is due almost exclusively to the balance of payments surplus in Japan. In the case of developing countries, accumulating reserves has been seen as a mechanism of "insurance" against possible financial crises and to avoid the excessive conditionality of the IMF. The international situation which characterised the boom which took place in the developing world between 2003 and mid 2008, characterised by abundant, cheap international financing and easy prices in basic goods, facilitated the accumulation. As graph 3 indicates, one of its effects was the massive fall in credits awarded by the IMF, which in fact was obliged to carry out a drastic programme of staff cuts.

Gráfico 4: International Reserves
(Thousand million dollars)



Fuente: Naciones Unidas (http://unstats.un.org/unsd/)

It is worthwhile adding that another mechanism with precautionary effects that was extensively used in the developing world after the Asian crisis was internal bond markets (public, but also increasingly, private), especially in national currencies (Ocampo and Tovar, 2008). The development of this market has aimed to overcome the imbalance in external liabilities, which implies, as we saw, that the depreciations that took place during crises tend to excessively increase the burden of foreign liabilities. The development of an increasing number of institutional investors in industrialised countries which invest in developing countries and the better debt security ratings of those countries (due both to the greater guarantee which growing international reserves offer) also contributed to this result although they might have generated new means of procyclical behaviour in external financing to the extent in which those flows respond to the expected behaviour of exchange rates in developing countries throughout the cycle (appreciation during the booms, depreciation during crises).

The accumulation of reserves for insurance reasons was, doubtlessly, a rational response at the level of individual countries to the risks of instability in the international financial system. We should point, however, that this mechanism has costs both for the countries as well as at a systemic level. Firstly, it involves the accumulation of assets whose performance is generally lower than that of foreign liabilities, and carrying out policies to "sterilise" the monetary effects of reserve accumulation that are very costly when internal interest rates significantly exceed the international rates, which is often the case (Rodrik, 2006). Secondly, reserve accumulation has "composition effects" that contribute to global imbalances. In order to accumulate reserves, developing countries tend to run a surplus in their balance sheet or to accumulate liquid liabilities, which creates a global recessive bias unless it is accompanied with deficit and financial assets from other countries, especially from the United States.

However, such deficit and liability accumulation cannot be sustainable and they generate corrections with both macroeconomic costs as well as costs to the financial sector. As we have already stated in the second section of this paper, if this behaviour is maintained, it could cause new imbalances in the coming years. We will return to this subject in the following section.

Finally, we should underscore that the Asian crisis led to a very important regional initiative, the Chiang Mai Initiative, adopted in 2000 by the ASEAN countries, China, Japan, the Republic of Korea (ASEAN + 3). The mechanism was initially conceived as a collection of reciprocal bilateral credits between the central banks of the member countries. Using this mechanism, countries could automatically pay out up to 20% (initially 10%) of the maximum of the credit lines agreed, from when they were obliged to adopt an IMF programme, which meant that the regional financing was seen as complementary and not a substitute to the IMF. In 2005, it was further agreed to make the credit lines agreed multilateral, so that, in accordance with the decisions adopted in 2007, a common reserve fund would be operate, but managed by each one of the countries and subject to a single contractual agreement. The corresponding multilateral agreement was signed in December 2009 and included resources totalling 120 billion dollars.

We should also add that an institution of this type was set up in the 1960s in Latin America, the Latin American Reserve Fund (which, despite its name, also has Andean countries as members, Costa Rica and Uruguay). In the last few years, an extensive number of regional and sub-regional macroeconomic policy agreements have been concluded, in keeping with macroeconomic sustainability, in the style of those adopted by members of the euro area (the Maastricht criteria).

The history of the last decade indicates, therefore, that an IMF that is more active as a lender of last resort and as a guarantor for the stability of the international financial system would reduce the national costs of the insurance policies of developing countries and would contribute to reducing the enormous imbalances in the balance of payments that characterise the world economy. Regional financing mechanisms could play a complementary role in this task and, in fact, the IMF should be seen in the future more as a network of reserve funds than as a mere global fund (Ocampo, 2006). A structure of this type would contribute both to global financial stability as well as to reducing world economic imbalances.

4. REFORMING THE GOVERNANCE OF THE WORLD BANK AND THE IMF

The tendency of developing countries to use unilateral solutions has also responded to their perception that they have an insufficient participation in international financial organisations. This has created a debate, which continues today, about changes to the votes and representation of those countries in the IMF and the World Bank.

In April 2008, a modest agreement was adopted on reforming quotas and votes in the IMF Board, which implies a redistribution of the quotas and a tripling of the basic votes to increase the voting rights of developing countries (including the emerging economies) by 2.7% as a whole. However, the reform has still not been ratified; it needs to be approved by 112

members representing at least 85% of total votes, and only 70 members, representing about 73% of the votes had done so at the time of writing of this paper. It is clear that ratification is a priority.

The ministers in the developing and transitional countries asked in the meetings of spring 2010 for an ambitious additional realignment of the quotas, which would imply an increase of 7% in the quotas of developing countries, mainly benefiting emerging economies. The specific reforms demanded by the developing countries demand greater weight being given for GDP to purchasing power parity and for more precise measures to be adopted in accordance with the needs of the borrowers, through an adequate assessment of the volatility that different countries face. One interesting reform that has been proposed that fits with the expectations of developing countries is to reduce the proportion of European votes in the IMF Board but to consolidate all the European Union seats in one, which would allow Europe to speak with a single voice in the Directory and even to increase its influence in this organisation.

An important proposal made on various occasions and that was reiterated by the IMF's Commission for Governance Reform, headed by Trevor Manuel (FMI, 2009c), is for the threshold of votes needed to approve important political changes in the IMF to be reduced from the current 85% to, for example, 70-75%. That would mean that the United States could no longer exercise a veto in the IMF Board on important policy decisions. This Commission also proposed accelerating the process to reform the quotas, that all seats were elected and that a Council of Ministers be formed to adopt the most important political decisions of the institution.

For its part, in the spring 2010 meetings, the World Bank approved a transfer of 3.13% of voting power from the developed economies to the developing and transition economies (DTEs, which include Saudi Arabia and South Korea). The DTEs will now hold 47.19% of voting power at the World Bank, and they have received a promise that they will reach parity in the near future. The greatest increase was for China, which gained 1.65% to become the Bank's third shareholder. The increases were mainly concentrated in middle-income countries, especially in Asia, which were under-represented, while low-income countries saw limited change. In the case of the developed countries, the European Union and Japan will see their voting power reduces but not the United States. The developing and transition countries saw this reform as a step in the right direction towards equal voting power at the World Bank, as expressed in the G-24 statement of April 2010.

The change in voting power will be achieved through an *ad hoc* capital increase. The objective is, however, to develop a formula based on principles for the next revision in 2015; developing countries expressed their clear preference for a more ambitious calendar. That reflects the fact that during the spring meetings there was no agreement on a new formula of dynamic participation, one which would capture the changing economic weight of the countries and the contributions to the development remit of the World Bank. Disagreements arose because many shareholders considered those principles, which followed the G-20 commitments at the Pittsburgh meeting in 2009 and the annual IMF/World Bank meeting in Istanbul, were not applied to the Bank's proposal, which was based almost totally in the economic weight of the countries. The Bank's development mission is important both for donors as well as for client countries. For the donors of the International Development

Association (IDA) and for borrowers from the developing world it is important to assign votes in accordance with the size of contributions to the IDA in order to incentivise larger contributions to the capital enlargement of the Association, which will benefit low-income countries. For medium-sized income countries it is also important to bear in mind the quality of their borrowers.

Finally, it is crucial for the heads of the IMF and the World Bank as well as the senior management of those organisations to be chosen on the basis of transparent and open processes, based on the merit of the candidates, without their nationality being an issue. It is encouraging that in the spring 2009 meeting between the G-20 leaders those principle was approved, and now it should be applied.. It would also be useful for the personnel of these institutions to be more diverse, not just in terms of nationality but also in terms of education and professional experience, and gender.

3. World macroeconomic imbalances and the reform of the international monetary system

1. THE WORLD'S MACROECONOMIC IMBALANCES

One field in which international financial architecture has monumentally failed is to provide a mechanism for guaranteeing consistent macroeconomic policies in the main economies in the world. These policies continue to be national in almost all countries, to a crucial degree in the economy which issues the main international currency, and a mix of regional and national policies in the euro zone, where monetary policy is now regional (although not for all members) but fiscal policies remain fundamentally national. That combined with an international monetary system and, in particular, with the world reserve system, which is still based to a large extent on a national currency, the US dollar.

The reforms that have taken place over time have added some positive elements to this architecture but they have also suffered significant setbacks and conflicts during certain periods. The creation of the IMF at Bretton Woods represented the most important attempt to establish a mechanism for macroeconomic cooperation based on rules that would allow each country to also adopt policies aimed at guaranteeing full employment (internal balance) and to correct fundamental external deficits (external balance) without causing negative effects on the international economy or on other countries. Countries were allowed to vary their exchange rates but to avoid competitive devaluations, which had contributed to the Great Depression in the 1930s, and the IMF provided partial multilateral financing to avoid policies correcting the balance of payments to have recessive effects with negative impacts on other countries. The IMF also offered a multilateral mechanism for macroeconomic dialogue and cooperation. These forms of international cooperation were also reinforced with the creation in 1969 of a true international reserve currency, the Special Drawing Rights (SDRs) issued by the Fund. Of course, not all the elements were positive since the Bretton Woods agreement put the dual dollar-gold standard at the centre of the international monetary system, which generated its own instabilities and finally collapsed in the early 1960s.

The collapse of the dollar-gold standard and the system of fixed parities and its substitution for a mechanism of variable parities between the main currencies introduced greater flexibility into the international economic system as well as more independence for national macroeconomic policies, at least for the main countries. It also introduced, however, new potential conflicts if the macroeconomic policies of the main economies were not moving in the same direction. In the last decade, for example, one endemic problem has been the imbalance between the trend by the US Federal Reserve to adopt clearly anticyclical policies and the reluctance (or, at least, greater caution) of the European Central Bank to do so. Possible tensions in monetary policy mean that the rise of alternative reserve currencies (the euro, in particular) - which may have risen from the scrapping of the dollar-gold fixed parity and the tendency to demonetise gold – could exacerbate instead of cushion world financial volatility and be reflected in the instability in the main currency exchange rates. In any case, the dominant tendency has been the use of the dollar as the main international reserve asset

(two-thirds in the last decade, according to IMF statistics), which means that the scrapping of the dual gold-dollar standard gave way to one fundamentally based on a fiduciary dollar – a "fiduciary dollar standard" as we will call it here.

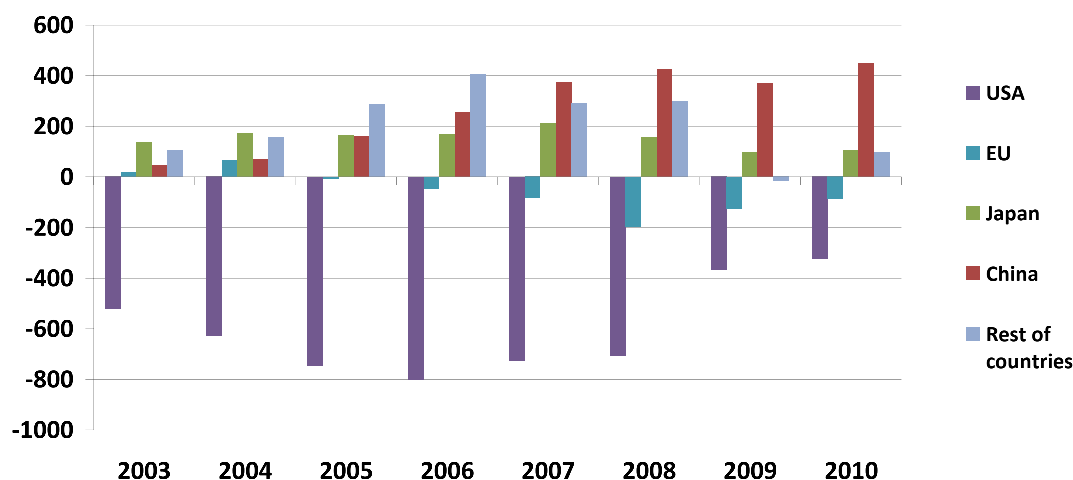
The macroeconomic coordination mechanisms put in place since the sixties have also operated outside the IMF and have not been particularly effective. In the eighties they were agreed on an *ad hoc* basis between the main economies (the Hotel del Plaza 1985 and the Louvre 1987 Agreements) and subsequently they worked through dialogues within the Group of 7 (the G-7), which clearly left out the main developing countries. The IMF took an interesting step in April 2006 when it created a "multilateral supervision" mechanism, the aim of which was precisely to consider the macroeconomic and financial interrelations between members of the Fund. That process involves the euro zone, Saudi Arabia, China, Japan and the United States, and its objective was to reduce world economic imbalances without sacrificing economic growth. Although the motivation of the new mechanism was positive, its results can be qualified at best as modest.

We should also mention that in June 2007 the IMF Board adopted a new resolution on supervision of countries' exchange rate policies, the first in almost 30 years. This resolution put the principle of external stability at the centre of the Fund's activities. To the old principles of currency exchange intervention, which already aimed to avoid exchange rate interventions which negatively affected other member countries, a new criterion was added: specifically to avoid exchange rate policies which generated external instability. From the outset China expressed strong reservations about this mechanism.

One interesting step in the direction of increasing the number of agents that took part in the dialogues and eventually in macroeconomic cooperation was the G-20 decision in Pittsburgh in 2009 to designate that Group "as a priority forum for our international economic cooperation" under the multilateral supervision of the IMF. However, that solution was only a partial step forward in the necessary task of placing the IMF again at the centre of world macroeconomic policies, as intended in its original design. The solution also created problems because of the *ad hoc* nature of the cooperation mechanism adopted.

The need for better macroeconomic coordination mechanisms became clear in the light of the large imbalances in trade balances that have characterised the world economy in recent periods and which are reviewed in Graphic 5. The strong external deficit of the United States and more recently those of the European Union contrast with the surplus of Japan, China and other developing countries, especially oil producers. The sharp increase in the deficit of the United States became acute during the Asian crisis when the expansion of the US economy served to cushion the recessive effects of that crisis at a world level. That deficit continued to grow until the middle of the last decade and was maintained at high levels until the start of the crisis despite the dollar's trend towards depreciation which began in 2003. During the world boom of 2003-2007, the insurance policy of the developing countries contributed to the generation of those imbalances as well as to a peak in prices of basic goods, especially oil and metals. The principle reflection of this was the rapid increase in the United States' net foreign liabilities – which reached US$2.1 trillion at the end of 2007 – and the strong depreciation of the dollar in international markets between 2003 and 2007.

Gráfico 5: Balances in current account
(Thousand million dollars)



Source: IMF, World Economic Outlook Database, October 2009
(http://www.imf.org/external/pubs/ft/weo/2009/02/weodata/index.aspx)

It can also be added that world imbalances were reduced as a result of the world crisis and especially, as a result of the substantial cut in the United States' deficit and in the surpluses of Japan and especially developing countries apart from China (see Graphic 5 again). Nevertheless, both the projections of the United Nations (2010) and the IMF (2009a) expect those imbalances to increase again from 2010 and subsequent years. The Fund's projection for 2010, shown in the Graphic, also indicate a worrying trend: the deficit of the United States and the European Union continue to fall, but the surpluses of China and the other developing countries increased. These individual trends imply that their net effect will be to reduce demand in the world economy – in other words, they will have a recessive effect – and in practice they will not work out as projected since the surpluses and deficits in the world will necessarily have to compensate for one another. This reflects the need to maintain expansive policies at a world level while improving the mechanisms for coordinating national macroeconomic policies so that these recessive trends do not materialise.

2. PROBLEMS WITH THE WORLD RESERVE SYSTEM

The magnitude of the recent international financial crisis brought out into the light the problems of the international monetary system and, in particular, the relationship between the world reserve system and trade imbalances – and in a wider sense between the system and international economic stability.

The world reserve system shows three fundamental deficiencies (Ocampo, 2009). All of them are related, in turn, to the fact that there is no mechanism, as highlighted earlier, to guarantee that surpluses and deficits in the trade balances of different countries offset one another without having negative effects on the world's economic activity.

The first problem, the one highlighted by John M. Keynes during the debates that led up to the creation of the Bretton Woods agreements, is that the present international monetary system – like all the systems that preceded it – has a bias against countries running a deficit (Keynes, 1942-1943). That tends to generate a global recessionary effect if the corrections that the countries in deficit need to adopt to balance their foreign trade accounts do not find financing in sufficient quantities (or if those countries do not think it is appropriate to maintain the deficits and the financing associated with them), and if, those adjustments are not offset by growth policies in the countries with surpluses. This problem can be called the *antikeynesian bias.*

The second deficiency, which has become known as the *Triffin dilemma,* after the pioneering work by Robert Triffin (1961, 1968), is to do with the fact that an *international* reserve system based on one *national* currency (the US dollar) – and, more generally, a limited number of national or regional currencies (the euro currently) – is inherently instable. The only way the rest of the world can accumulate net assets in dollars is if the United States runs a current account deficit. But such deficits can lead to a loss of confidence in the dollar and, more generally, to strong cycles in the value of the main international currency and the current account of the country that issues it, which strongly affects the rest of the world economy. Deficits also encourage the excessive growth in credit in the United States and price bubbles in financial and property assets, which generate the risk of financial crises.

Being the centre of the world monetary system means that, apart from the privilege of being the center of the system, the United States also benefits from having its deficits cheaply financed through the reserve accumulation of the rest of the world. Moreover, the United States also enjoys the additional privilege of being able to carry out a relatively autonomous monetary policy – and even to impose it on the rest of the world. The basic reason for this is the perception (and subsequent use) of the securities from the US Treasury as the "safest assets", which means that the determinants of the US rates of interest are relatively independent of the dollar's exchange rate against other currencies.

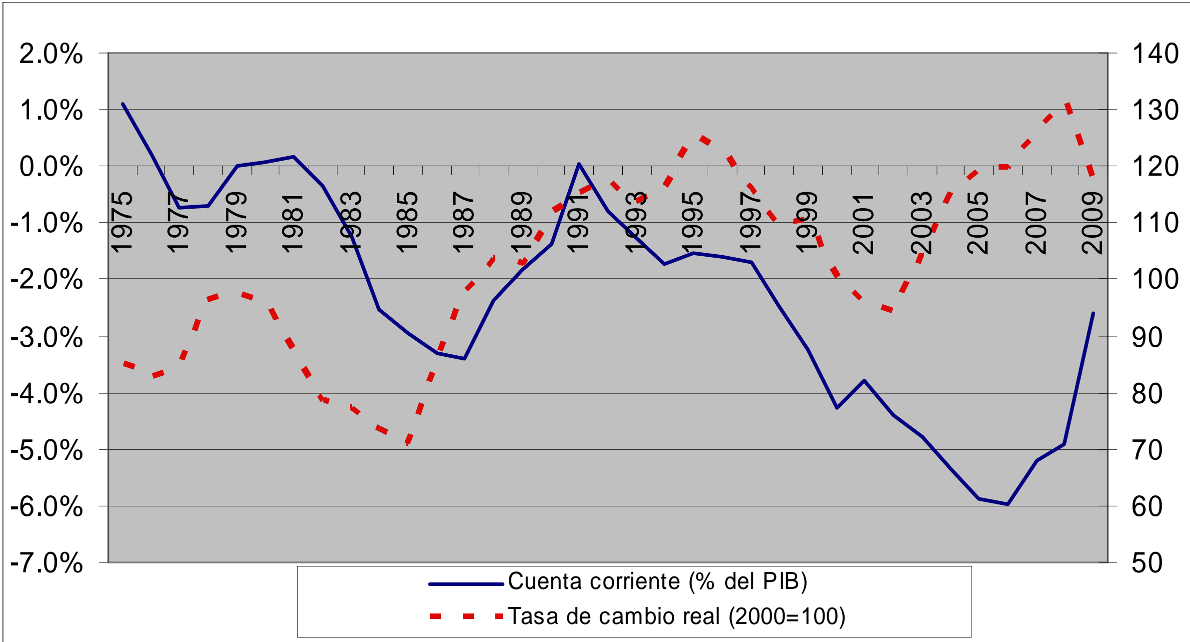
For this reason, the United States has not generally considered the real or probable weakening of its currency as a significant problem that needs to be corrected. The absence of restraints on the US monetary policy has meant that, in contrast to Keynes' classic theories on the recessionary bias in the international monetary system, the fiduciary dollar standard by which the world economy has functioned for the last four decades can produce exactly the opposite phenomenon during certain periods: an inflationary bias. The boom which preceded the recent crisis could be considered the most noteworthy example of this type of case.

The third deficiency in the current reserve system is its inequitable nature. As we have already highlighted, the need to accumulate international reserves obliges developing countries to transfer resources to those countries that issue reserve currencies. This *bias towards inequality* has been magnified in the last few decades by financial and capital market liberalisation, by the strongly procyclical behaviour of the capital flowes towards developing countries. This behaviour has generated, as we see, a massive accumulation of international reserves as a form of insurance against abrupt interruptions in foreign financing. This accumulation can also be seen, as we have also shown, as a rational response by each country to a system that lacks a "collective insurance" in the form of a good IMF emergency financing system. It also

generates the "composition fallacy" already mentioned, which worsens the distortions in the world balance of payments and can generate, as we saw, a recessionary bias. We could call this problem the *inequality-instability* link.

The three problems mentioned have been clearly present in the behaviour of the world economy. The first and the third have already received attention in previous sections of this paper. The recessionary biases that could present themselves in the next few years if a considerable number of countries try to improve their current account balance (by reducing their deficit or increasing their surplus) will generate recessionary biases in the world economy, as we stated at the end of the previous section. The massive accumulation of reserves by developing countries and their contribution to world economy imbalances is the clearest demonstration of the third, as we saw in the second part of this paper.

Under the fiduciary dollar standard by which the world has lived, deficits in the United States' balance of payments have been the rule rather than the exception. During the past three and a half decades, the world has seen itself devastated by an ever more intense cycle of growth and contraction in the US current account deficit, which is linked to strong fluctuations in the real exchange rate of the main reserve currency, as we can observe in Graphic 6. That implies that the dollar has increased lacked the main characteristic that a currency should have to be at the centre of the system: a stable value. Moreover, corrections to the US current account have also taken place in a context of world economic downturn, as the recent crisis confirmed yet again.



Source: IMF Internacional Fianancial Statistics. The increase in Real change value shows a real depreciation (contrary to IMF convention). It is estimatedas the inverse of the real change value calculated by the Fund.

The interaction between the three problems mentioned is particularly clear in the behaviour of the US deficit from the end of the 1990s. As graph 6 indicates, at the end of that decade the phase of the greatest deterioration in the US current account in its history began. Although it had its equivalent in the deterioration of the internal deficits of the United States, particularly among households, it should be recognised that the huge size of the current account imbalances are also a result of external factors to the US economy. Among those is the combination of the appreciation of dollar and the abrupt divergence between US and world growth generated by a recession in a large part of the developing world from 1997. The United States deficit served, therefore, to mitigate the antikeynesian bias generated by the massive crises experienced back then by the developing countries.

On the other hand, although the strong US and global deceleration of 2001 allowed the US deficit to be reduced, the effect was moderated in relation to similar downturns in the past, and the upward trend in the deficit began again the following year. Although that increase is linked again to internal problems in the US economy, it is also related to developing countries' strong demand to protect themselves, which was reflected in current account surpluses and reserve accumulation, especially by developing economies in eastern Asia and the oil exporters. This is why the strong but orderly accumulated depreciation of the dollar since 2003 was not accompanied, as was the case in the second half of the eighties, by a significant correction in the United States' current account deficits, which only started in 2008 as a product of the deep US recession – and a world crisis.

3. REFORMING THE SYSTEM

Among the alternatives for reforming the international monetary system, the first would be to transform the current system into one based on multiple reserve currencies that compete between each other. That alternative is, in fact, already implicit in the system that has operated since the early seventies and would therefore be in some senses a convenient solution. However, it is not clear that the system would necessarily evolve in that direction, as the problems that the euro has faced during some phases of the current crisis, especially at the end of 2008 and early 2010 when the currency experienced strong downward pressures as market agents distrusted the solidity of some members of the monetary union.

Additionally, and more importantly for the subjects of this paper, a system of this type would not correct the main problems of the current monetary standard. It would do nothing to correct the antikeynesian bias and each currency would be an unstable value and so would lack what we earlier highlighted as one of the essential characteristics for a reserve currency: its stability. Although this model would offer developing countries the advantage of being able to diversify the composition of their reserves, they would be invested in all forms of industrialised country assets, which would maintain the generation of a transfer of resources from developing countries to the industrialised nations. One exception would be for the renminbi to become the reserve currency but that possibility seems a long way away and would only benefit one developing country transformed into a world power.

Curiously, flexibility in exchange rates between the main reserve currencies constitutes both the main advantage and disadvantage of the system. The advantage is that it would allow a

competitive system of reserve currencies to resist attacks on fixed parities that ended up bringing down both the silver-gold standard in the 20th century and the gold-dollar standard in the early 1960s. However, that flexibility adds an additional element of instability to a system purely based on the dollar, due to the volatility in the exchange rate between the main reserve currencies – a problem that is, in some ways, already present in the current system. Such volatility generates significant profits and losses for the central banks in dealing with their reserves and it eliminates one of the characteristics that reserve assets should have: to be "safe" or low risk. That is its principle disadvantage.

This disadvantage would be exacerbated if central banks responded to fluctuations in exchange rates by changing the composition of their international reserves, thereby feeding exchange rate instability. Under those conditions, a system of multiple reserve currencies could generate growing demand for the adoption of an agreement for fixed exchange rates – in other words, a return to the Bretton Woods scheme, at least for reserve currencies. However, setting exchange rates between the main currencies in a world characterised by high capital mobility would be a difficult, or even impossible, task. We should add that, given the high demand for international reserves, developing countries suffer from exchange rate instability in reserve currencies disproportionately.

All that implies that the main deficiencies can only be resolved by a deeper reform of the world reserve system. Although other alternatives could be designed – such as the Keynes' proposal to create a mechanism for international compensation and other similar solutions[4]– the most viable consists in completing the transition started in the sixties with the creation of the Special Drawing Rights (SDRs). That involves placing a world currency with a fiduciary character at the centre of the system, completing the evolution of national and international monetary systems started in the 19th century (Triffin, 1968). Given the procyclical nature of the capital movements that developing countries face, as well as the high demand for international reserves that such behaviour generates, the adoption of a scheme of this type should be accompanied with other initiatives aimed at guaranteeing the placing of the SDRs be used to correct, at least partially, the problems that developing countries face under the current system.

Obviously, the role of the SDRs has changed since the early 1970s with the transformation of the international monetary system towards a fiduciary dollar standard. The questions related to adequate international liquidity, which were the fundamental concern during the first periods after the war, and which were still the centre of debate in the seventies, are no longer important except during extraordinary situations like those caused by the severe liquidity crunch that was the fallout of the world financial collapse in September and October 2008. As we have seen, the fiduciary dollar standard can show an inflationary bias, which reinforces the peaks and troughs of the world economy, as happened in 2003-2007. Nevertheless, other problems that were also the object of attention in the sixties, continue to be fundamental or even more important today, especially those linked to the composition of world reserves, the access of developing countries to liquidity and questions of equity related to both processes.

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[4] See, for example, Stiglitz (2010) and D'Arista (1999), as well as the interesting proposal made in the sixties to create a reserve system based on commodities, which presented particularly interesting anticyclical characteristics (Hart, Kaldor y Timbergen, 1964).

After the initial allocations carried out in 1970-1972 and 1979-81, no more allocations were made for almost three decades. The last of those, approved by the IMF in 1997, for 21.4 billion SDR, only came into effect in mid-2009 with the approval by the United States of the change in the IMF's Founding Agreement to which it was party. The current crisis, however, generated renewed interest in this mechanism for international cooperation, as reflected in the G-20 proposal, subsequently approved by the IMF, to allocate the equivalent of 250 billion additional dollars, of which little short of 40% benefited developing countries under the current system of quotas. That meant the SDR in 2009 reached the equivalent of 283 billion dollars. Although that is an important sum and meant that the SDR represented 5% of world reserves, that proportion remains inferior even to when the first allocations were made in 1970-1972, when they reached 10% (Williamson, 2009). The suspension of the SDR for more than a quarter of a century had negative effects for developing countries because it coincided with an increase in demand in the international reserves of those countries.

We should highlight that any attempted international monetary reform should involve a considerable increase in the size of the IMF, which has been significantly lagging behind the size of the world economy since the revision in its quotas of 1998 and since the sixties in comparison to the magnitude of the capital flows at a world level (IMF, 2009b). Obviously, the form in which the Fund obtains its resources is essential. The SDR allocations and the quota increases are much better mechanisms than "loan agreements" in their different forms – the main option chosen by the G-20 in April 2009, as well as in the past, to grow the resources available for the Fund during times of crisis.[5]

The creation of a system based to a greater degree on the SDR would contribute to a large extent to resolve both the Triffin dilemma as well as the distributive effects caused by the use of the US currency as the principle reserve asset. In the last few years, the proposals to increase the SDR issues have followed two different models. The first consists in carrying out SDR issues in an anticyclical way, concentrating them basically in periods of crisis and possibly destroying them once financial conditions normalise (United Nations, 1999; Camdessus, 2000; Ocampo, 2002). That would create an anticyclical element in the handling of international liquidity. The second model proposes regular SDR allocations equivalent to the additional reserve demand at a world level, so at least 100-150 billion dollars a year, even if we apply the exceptional recent period in reserve accumulation, although it should reach at least double that sum. That is also the size of the SDRs that should be issued in the long-term for anticyclical purposes. One alternative that combines these two options would be to make regular issues, but to keep them inactive and make them effective only under pre-established conditions.

One fundamental problem this reform faces are the current IMF quotas that are also the basis for issuing the SDR and do not reflect the realities of today's world economy. Apart from the subjects that have been the object of discussion in recent debates on the Fund quotas, which have led to marginal improvements, the most important issue is the enormous gap between the demand for reserves from developing economies and industrialised ones, which is at the heart of the inequalities in the world reserve system and the inequality-instability link spelt

[5] See Kenen (2001) on the deficiencies of loan agreements.

out above. The problem can only be corrected through a reform or a combination of four types of reforms (since they are not mutually exclusive).

The first would be to include international reserve demand as a criterion for the SDR allocations, which would mean in practice awarding a large part of the issues to developing countries.

The second consists in linking anticylical SDR issues to the IMF financing during crises in order to thereby improve the provision of a "collective insurance" against balance of payment crises. One option to do that would be to consider those SDR that are not used by countries to be deposits (or loans) to the IMF, which could be employed by the institution as loans to countries requesting resources.[6] Of course, for this task it is essential to improve the Fund's credit lines and their conditionality in order to overcome the stigma associated with loans from this institution. Another option that could be considered is to adopt at least part of Keynes' original plan: to create a drawing line that can be *unconditionally* used by *all* IMF members for a pre-established sum and period. Another possibility, which might be more politically feasible, would be for the IMF to grant unconditional credit to countries suffering shocks that have clearly foreign origins, whether the shocks affect a country's capital account or its current account. The compensatory credit line, which was scrapped in March 2009, worked when it used light conditionality rules.

The third proposal would be to create an explicit "development link" in the SDR allocations (which could be an alternative or a complementary proposal to the first one). One of the proposals along these lines is to use the SDR allocation corresponding to industrialised countries to finance official development aid and the provision of global public goods (Stiglitz, 2006: Chap. 9). This suggestion has many advantages, but poses the problem of such transferrals being fiscal, and therefore they might need approval by each respective national parliament. An alternative to this would be a similar scheme to the one suggested by the Group of Experts gathered by UNCTAD in the sixties (UNCTAD, 1965): allow the IMF to buy bonds from multilateral development banks to then finance the long-term resource demands of developing countries.

The fourth proposal would be to encourage the creation of funds or other *regional* reserve agreements in developing countries – such as the Latin American Reserve Fund the the Chiang Mai Agreement mentioned earlier – that would provide a complementary form of collective insurance. One very important incentive to such regional agreements would be a provision under which the SDR were proportional not just to the IMF quotas but also to the reserves the developing countries would have brought to regional reserve funds (United Nations, 1999, Ocampo, 2002).

Lastly, there are two complementary reforms that many analysts consider necessary to consolidate the role of the SDR in the international monetary system. The first is to allow the use of the currency in some transactions in the private sector (see, among others, Kenen, 1983). Of course, there are different intermediate methods: to allow the use of the SDRs only

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[6] That would involve eliminating the division between the denominated General Resource Account and the SDR. See Clark and Polak (2004) and Cooper (1987: Chap. 12).

for specific purposes, like setting no regulatory obligations on capital requirements or liquidity in financial institutions.

The second would be creating a "substitution account", a suggestion made at the end of the sixties when the dollar faced negative pressures. That account would allow countries to exchange their dollar assets for SDR assets issued by the IMF without putting pressure on the dollar in the market. A system like this would give more stability to the current monetary standard and would be, in any case, a necessary transition mechanism for a world reserve system based on SDRs. The IMF decision of July 2009 to allow the issuing of securities denominated in SDR to draw in resources from some emerging economies (Brazil, China and Russia) can be considered a step in that direction. The fundamental problem, underlined in the debates of the sixties, is how to distribute the losses that the IMF could incur with a mechanism of this type. That said, those costs are not necessarily very high. Retrospective calculations done by Kenen (2009), as if the mechanism had been in place in the period 1995-2008, indicated that losses would have been minimal.

The current context could be a good moment to introduce these reforms. Firstly, the inflationary risks associated with SDR issues are low and, on the plus side, such issues could reduce the recessionary bias that the world economy is facing because of the fear of running up deficits that arise from the trends in world trade imbalances. Secondly, the United States has embarked on a huge fiscal deficit and an aggressive monetary strategy. That has potential implications for the stability of the current reserve system, as some countries have pointed out, China especially (Zhou, 2009). In reality, under the current circumstances, the northern American country could find its central role in the global monetary system rather uncomfortable since it could be an obstacle to its freedom in economic policy.

In any case, abandoning the dollar as the chief world *reserve* currency is consistent with it maintaining its role as the principle international *payment method*, unless SDRs become used in larger financial transactions. The use of the dollar as a payment method increases demand for the US financial system and has other implications for the country that have been explored by other authors (see Cooper, 1987: Chap. 7 for instance). It clearly remains to be seen whether the crisis under way will have permanent effects on the role of the United States as the world's main banker.

4. By way of conclusion: an overall look at reform of international financial architecture.

The Asian crisis of 1997 and its move to Russia and Latin America led to great interest in reforming international financial architecture. A decade later and in the face of what was the prelude to a new financial crisis, which had its epicentre in the main world economy, progress on reform has been clearly disappointing. In fact, world economic imbalances were probably more pronounced than at any time since the Second World War, the regulatory deficit in the most developed financial markets was massive and the IMF found itself undergoing its worst crisis in its history.

One positive aspect about the period 1997-2007 was the definition of a broad consensus on international financial and development reform, the Monterrey Consensus, adopted in 2002. The following conference on the Monterrey agenda, carried out in Doha (Qatar) at the end of November 2008, and the Summit on the global financial and economic crisis and its impact on development that the United Nations called in June 2009, were important opportunities to look again, in the United Nations, at problems of international financial cooperation. The Doha conference was preceded not just by the eruption of the global financial crisis but also by the creation of the G-20 at the level of leaders, which began by adopted aid initiatives in various fields.

The main progress throughout the decade of 1997-2007 was centred on strengthening macroeconomic schemes and the financial regulation of developing countries and in creating or deepening local bond markets in those countries. In turn, those countries responded to the absence of a good collective world insurance mechanism against financial and balance of payment crises with their own massive insurance, through an unprecedented accumulation of international reserves. Add to that, in eastern Asia, the Chiang Mai Initiative, which created a regional mechanism to support countries during crisis. At an international level, some IMF credit lines were improved and a failed debate took place on the introduction of a multilateral mechanism to solve sovereign debt crises.

The efforts that the developing countries themselves made are, therefore, the main developments in international financial reform in the period 1997-2007. The main paradox of that was that international reform was based more on the *national* reforms carried by developing countries than on a true reform of the *international* financial architecture. Those efforts served during the global crisis of 2007-8 to help to somewhat cushion developing countries from its impact.

As a result of the global financial crisis that hit in September 2008, there have been important advances. Among them is the renewed issuing of SDRs and the creation of new IMF facilities, as well as the widening of existing ones to poor countries, and the proposals under discussion for the introduction of an international tax on large currency transactions. There have also been huge debates and commitments to make important financial regulatory reforms in the main industrialised countries. Nevertheless, these last developments have only partially materialised, principally because of opposition from financial sector interests.

One important realisation, which came to fruition after the Asian crisis, was the need for a world governance structure where developing countries had adequate "voice and representation" in world economic decisions, to use the terminology of the Monterrey Consensus. This representation in the period 1997-2006 was in some cases inadequate (the IMF and the World Bank) and in other cases partial (the International Settlements Bank) or non-existent (the Basel Committee and the Financial Stability Forum). Greater representation would achieve part of a larger process for the structure to reflect that of today's world economy and not that of the years after the Second World War when the Bretton Woods organisations were created. An additional element is the veto that the United States has had on the main IMF decisions, beyond an excessive informal influence, that became particularly clear during the Asian crisis.

The IMF made some steps on "voice and representation" for developing countries in 2006, although they were relatively timid. The World Bank initiated discussion on the issue afterwards and that is still ongoing. It is worthwhile highlighting that in both organisations the changes that the world economy has experienced demand a greater weight be given to Asian developing economies at the expense mainly of European countries. That could be achieved, even in a manner consistent with maintaining or increasing European influence in those organisations, if a seat was created to represent the European Union and not individual countries. We should also add that the reform proposals have shown the need to also increase the voice of the poorest countries in international organisations. However, given the loss of participation of those countries in the world economy, the only solution in their case is to increase the basic votes of the poor countries in international institutions. That method was adopted in the IMF reforms of 2006.

The most important changes in terms of governance that the international financial crisis produced was, as underlined, the creation of the G-20 at the level of world leaders. The G-20 had previously operated since its creation after the Asian crisis as a forum for tax ministers, which had relatively little impact. One of the G-20 decisions was to give access to all its members to regulatory organisations on financial matters, especially to those assigned the task of coordinating the tasks of world financial reform, the renamed Financial Stability Board (previously Forum). These reforms therefore increased the representation of developing countries on those organs. Although that represents progress, it also throws up serious questions, given the *ad hoc* way in which the membership of such organisations are defined, which implies the exclusion of some large countries (Nigeria is the case that most stands out). In this sense, the creation of the G-20 at leadership level should be merely seen as a transition to a representative, and thereby legitimate, mechanism.

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