

POLICY RESPONSE TO THE GLOBAL FINANCIAL CRISIS: KEY ISSUES FOR DEVELOPING COUNTRIES

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I INTRODUCTION

The global financial crisis triggered by widespread speculative lending and investment in major international financial centres poses two sets of policy challenges. First, it calls for an immediate policy response in order to stabilize financial markets and international capital flows, halt economic decline and initiate recovery. So far major industrial countries have taken a range of measures for these purposes, including bailout operations through infusion of capital into weakened financial institutions and industrial firms and government guarantees for impaired financial assets and bank deposits; significant easing of monetary conditions and speedy and sharp reductions in interest rates; and large fiscal stimulus packages. Developing and emerging economies (DEEs) have also adopted measures to ease credit conditions and stimulate private spending to counter destabilizing and deflationary impulses from the crisis. However, several of them face resource constraints in responding to the crisis with countercyclical policies. There is a strong rationale and some scope for using trade and financial policies to ease the resource constraint. But, in many cases effective policy response depends crucially on the provision of adequate international liquidity at appropriate terms and conditions through multilateral financial institutions.

Secondly, this crisis has indicated once again the need for a fundamental reform of the international financial system in order to secure greater stability and prevent virulent crises with global ramifications. A consensus appears to have emerged among the major players in the world economy on the need for reform and a number of ad hoc initiatives have been launched and proposals put forward in various fora including the United Nations, the Group of 20 and the Bretton Woods Institutions. But to what extent these will result in the kind of changes needed is highly uncertain. The past record in this respect is not very encouraging. Despite a wide agreement on a systemic reform to bring about more effective governance to international finance after a series of crises in emerging economies in the 1990s and proliferation of proposals for reform, the *Financing for Development* initiative launched has yielded no significant outcome in this respect in the past seven years.² DEEs have a considerably greater stake in such a reform in view of disproportionately large damage that international financial instability inflicts on them. It is therefore important that they lead the process and form a coherent view for real change in a broad range of areas of crucial interest to them, including the mandate, resources, operational modalities and governance of the IMF, so as to reduce their vulnerability to financial instability and crises while preserving adequate policy autonomy in managing their integration into the international financial system, and capital flows and exchange rates.

These two sets of issues overlap in certain respects. In particular many of the shortcomings in the immediate policy response to the crisis by the international community have their roots in the deficiencies in global institutional arrangements for crisis management and resolution. The next section will discuss the constraints DEEs are facing in responding to deflationary and destabilizing impulses from the crisis, making an assessment of the international initiatives undertaken so far to provide support. This is followed by a discussion of the reform of the international financial architecture under two headings; crisis prevention

² See, Akyüz (2002) for the issues raised and proposals made after the Asian financial crisis.

and crisis intervention and resolution. Discussions will focus on issues that are viewed as of particular importance for stability and growth in DEEs, rather than on every issue raised by the current crisis. The final section will give a summary of the policy proposals advanced in the paper.

II POLICY RESPONSE IN DEES: PAYMENTS CONSTRAINT AND INTERNATIONAL SUPPORT

II.1 Crisis impact and domestic policy options

The fallouts from the global financial crisis are wreaking havoc in DEEs. The combination of sharply declining commodity and manufactured export earnings, collapse of remittances, reversal of private capital flows, rising risk spreads, an extreme degree of credit squeeze affecting even trade finance and losses of asset values is giving rise to a sharp economic slowdown and even contraction in many parts of the developing world. According to the most recent projections by the IMF, average growth in DEEs is expected to be as low as 1.6 per cent in 2009, down from 8.7 per cent in 2007. At more than 6 percentage points, the expected loss of growth in these economies exceeds that in the centre of the crisis, the United States economy where output is projected to contract by 2.8 per cent in 2009 after growing by 2 per cent in 2007. This deceleration will result in sizeable drops in per capita incomes in most developing regions and countries. Consequently, there is a risk of reversal of many of the benefits achieved in poverty alleviation and development as a result of intense policy efforts and reforms carried out in recent years.

There is now a broad agreement on the need for expansionary, counter-cyclical macroeconomic policy response to deflationary impulses emanating from the crisis. It is also agreed that under current conditions of extreme liquidity preference and risk aversion, monetary policy would have very little impact on credit expansion and private spending. Consequently, the burden falls primarily on expansionary fiscal policies, particularly increased public spending.

The main impediment to countercyclical macroeconomic policy in many DEEs is the balance-of-payments constraint. Although several middle-income countries have succeeded in building up relatively strong payments positions and large stocks of international reserves during the preceding expansion, the balance-of-payments constraint has generally become tighter with declines in exports earnings and the reversal of private capital flows. Indeed reserves have been falling almost everywhere in the developing world and even strong surplus economies such as China has been experiencing capital outflows. An acceleration of growth based on the expansion of domestic demand would certainly drain reserves further as imports pick up, exerting pressure on the currency and threatening external and financial stability. This means that for resource-constrained DEEs expansionary macroeconomic policies would depend crucially on the provision of adequate external financing. For poorer countries where official flows are directly linked to the budget, injection of additional external financing would also help ease the fiscal constraint which has generally become tighter as a result of adverse effects of declines in exports earnings and incomes on government revenues and of currency depreciations on public external debt servicing.

According to the World Bank (2009: p. 6), external financing needs in 2009 are expected to exceed private sources of financing in 98 of the 102 DEEs. In the absence of adequate official financing to fill the gap, these countries would have to use whatever domestic policy instruments they have under their control in order to weather the crisis with minimum damage. But options are quite limited. Currency adjustments would not be very

effective in promoting exports when markets abroad are shrinking. Sharp devaluations in countries with extensive liability dollarization could also create deleterious effects on private balance sheets with large currency and maturity mismatches.

By contrast, selective restriction of non-essential, luxury imports, as well as of imports of goods and services for which domestic substitutes are available, could be more effective in easing the payments constraints and facilitating expansionary macroeconomic policies by allowing increased imports of intermediate and capital goods needed for the expansion of domestic production and income. For some DEEs the space between applied and WTO-bound tariffs can provide adequate room for such an action, but the margins are generally quite narrow and even non-existent for a large number of DEEs. By contrast, under current conditions prevailing in many countries, there is a strong rationale, as a last resort, for invoking GATT (and GATS) balance-of-payments safeguard provisions, notably those of Article XVIII B which are directed particularly at payments difficulties arising from a country's efforts to expand its internal market or from instability in its terms of trade.

Ideally, when global deflationary forces are at work, it would be highly desirable to avoid restrictive trade measures, particularly those of a discriminatory nature. Indeed the interwar experience shows that ad hoc, discriminatory trade restrictions, together with beggar-my-neighbour exchange rate policies, can aggravate, rather than ease economic difficulties and lead to conflicts. The recent G20 summit pledged not to "repeat the historic mistakes of protectionism of previous eras" and to "refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organisation (WTO) inconsistent measures to stimulate exports" (G20 2009c: para 22). However, there was no indication of what kind of actions would be considered as protectionist and what kind as WTO-consistent. Nor was there any specific commitment.

Whether or not a particular trade measure can be considered as protectionism depends on the conditions under which it is adopted. In this respect a distinction should be made between restrictions applied by reserve-currency and reserve-rich countries, and those applied by DEEs facing balance-of-payments constraints. Import restrictions in the former cases would effectively imply exporting unemployment abroad, since by raising net exports such an action would substitute foreign for domestic demand. But this would not be so for restrictions applied by DEEs facing shortages of international liquidity. In this latter case, the alternative would be to face stagnation or contraction, and hence reduced demand for foreign goods and services. Selective restrictions over imports would allow allocation of scarce foreign exchange to facilitate domestic expansion without reducing the overall demand for foreign goods. This cannot be considered as a protectionist action.

Thus, resource-constrained DEEs should not be denied their rights embodied in multilateral trade agreements to use legitimate measures so as to avoid contraction in economic activity. Such trade measures should be distinguished from beggar-my-neighbour import restrictions and subsidies, including those used by some major industrial economies - such as the "Buy American" provisions and industrial subsidies in United States stimulus and bailout packages - which serve to protect jobs at home rather than facilitate expansionary policy actions, and beg the question of conformity to the WTO rules.

A second set of measures that could be employed by countries facing shortage of international liquidity to support domestic expansion relates to the capital account. DEEs are

now experiencing net outflows on portfolio investment and international bank lending. Furthermore, residents in several of these countries have joined international lenders and investors in capital flight. This is in large part the outcome of widespread liberalization of resident investment abroad in recent years, often in an effort to relieve the upward pressure of the surge in capital inflows on currencies. Clearly, to the extent that reserves, exports earnings and official lending are used to finance capital flight, international liquidity available for current account financing would be reduced. Furthermore, under present conditions capital flight would also compromise the ability to use monetary policy for expansion. Thus, there is a strong case for restricting capital outflows in countries facing rapid loss of reserves. Restrictions would also widen the space for counter-cyclical monetary and fiscal policy response to the crisis in order to stabilize economic activity and restrain declines in currencies and the consequent dislocations in private balance sheets.

II.2 International liquidity support

The extent to which trade and financial restrictions would need to be applied by resource-constrained DEEs depends on the speed with which international trade, financial markets and capital flows are stabilized and on the availability of adequate financing from multilateral financial institutions. In the latter respect a number of initiatives have been taken in the G20 and the Bretton Woods Institutions in recent months, seeking improvement in three main areas: increased funding for multilateral financial institutions, widened access of DEEs to multilateral financing, and improvements in the terms and conditions of multilateral lending. Some of these initiatives have implications that go beyond matters of immediate policy response to the crisis and could, in fact, entail systemic and more permanent changes in the way the IMF intervenes in financial crises. These features will be discussed in the subsequent section in the context of the reform of the international financial architecture. Here a brief description will be given of the steps so far taken in the three areas, an assessment will be made of their adequacy in meeting immediate policy challenges for stabilizing economic conditions in DEEs and preparing the ground for recovery, and proposals will be made for further action.

Regarding new resources, according to the agreement reached in the April G20 summit, commitments have been secured for an additional \$1.1 billion for international support. This includes a decision to allocate \$250 billion of Special Drawing Rights (SDRs), approved in the subsequent meeting of the IMF; trebling of resources available to the IMF to \$750 billion; an additional \$100 billion for multilateral development banks, presumably to be raised through bond issues;³ and \$250 billion trade finance from various public and private institutions including export credit agencies. Of the additional \$500 billion for the IMF, only \$250 billion is readily available through bilateral lending by some of its major shareholders, to be subsequently incorporated into an “expanded and more flexible” New Arrangements to Borrow.⁴ However, there does not seem to be an agreement on how the rest should be raised.

³ The World Bank has also set up the Vulnerability Financing Facility for countries hardest hit by the food and financial crises, but its potential contribution to crisis response in DEEs is not very clear.

⁴ The Fund has two agreements for bilateral borrowing from its shareholders; the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). GAB was established in 1962 on the basis of the provisions of the Articles of Agreement (Article VII, Section 2) for replenishment of scarce currencies, which gave birth to G-10. It has been renewed ten times, raised from the original amount of SDR6 billion to SDR17 billion in 1983 in response to the debt crisis. NAB was established in 1998 as a set of credit arrangements with 26 members, for a total of SDR17 billion and renewed twice since then. In both GAB and NAB commitments by individual countries are based on their quotas. Between the two the total amount available to the Fund is around \$50 billion.

While some major shareholders favour increasing the NAB by an additional \$250 billion and encourage reserve-rich economies to make bilateral loans, major emerging economies, notably China, India, Russia and Brazil appear to insist that these resources be raised by borrowing from the markets, and have expressed interest in buying short-term notes (bonds) that the Fund could issue for this purpose.⁵ This matter is now under consideration in the Fund.

Regarding access of DEEs to multilateral financing, the major recent initiatives include, in addition to the agreement on the SDR allocation noted above, doubling the normal access limits in the IMF; doubling of borrowing limits for poorest countries eligible to Poverty Reduction and Growth facility (PRGF) and Exogenous Shock Facility (ESF); and a new Flexible Credit Line (FCL) established for crisis prevention in emerging economies facing contagion from the global crisis. The FCL is said to be available “for countries with strong fundamentals, policies and track records of policy implementation”, to be assessed by the IMF according to several pre-determined criteria. It can be drawn or used as a precautionary instrument. Unlike the Short-Term Liquidity Facility (SLF) it replaces, the FCL has no hard cap.⁶ However, it is not clear if this implies that the Fund will act as a lender-of-last-resort to countries it deems eligible, lending in unlimited amounts and without conditions except for penalty rates. So far a \$47 billion FCL arrangement has been approved for Mexico. Poland has requested some \$20 billion as a precautionary FCL arrangement and Colombia has expressed interest in a similar arrangement for \$10 billion.

Finally, certain steps have been taken for “modernizing IMF conditionality for all borrowers” as part of the overhaul of the IMF lending framework.⁷ First, access to the FCL will be based on *ex ante* rather than *ex post* conditionality. Second, decision has been taken to discontinue structural performance criteria in all Fund arrangements including those with low-income economies. This is expected to allow the Fund to focus on core objectives.

It is difficult to make a precise judgment on whether these initiatives would meet the external financing needs of DEEs since this crucially depends on the effectiveness of the measures adopted by the advanced economies responsible for the crisis in restoring stability and growth. According to the World Bank (2009: p. 6), the total external official financing needs of the 98 DEEs with shortfalls are expected to be at least \$270 billion, and this figure could go up significantly, reaching \$700 billion. According to UNCTAD (2009) the gap could turn out to be \$2.000 billion. While the G20 summit is claimed to have come up with a commitment for an extra \$1.1 trillion, the real additional amount readily available appears to be lower, certainly much less than the latter figures.⁸ It is notable that despite these highly-publicized initiatives for additional financing for DEEs, the April 2009 growth projections by

⁵ See, New York Times, “IMF Planning to Sell Bonds to Finance New Loans”, April 26.

⁶ The SLF was introduced in October 2008 with the deepening and global spread of the crisis for members with “solid policy track records and strong fundamentals” and access was based on ex-ante qualification. Unlike the FCL it had a cap of 500 per cent of the quota and it could not be used as a precautionary credit line. It remained unused until replaced by the FCL. Members who do not qualify for the FCL can use the so-called High-Access Precautionary Stand-by Arrangements (HAPAs) on a precautionary basis, with a cap and frontloading subject to ex-post review; see, IMF (2009a).

⁷ See, IMF Press Release 09/85, March 24, 2009.

⁸ In particular the additional \$250 billion for the Fund is not yet in sight, the source of the additional \$100 billion for the World Bank is not clear, and the so-called \$250 additional money for trade financing seems to be fictitious-see, Giles (2009) and Khor (2009).

the IMF for these economies show downward revisions by 1.7 percentage points for 2009 and 1 percentage point for 2010 from those given in January 2009 – more or less by the same amounts as for advanced economies (IMF 2009b; table 1.1).

The volume, terms and conditions of additional financing to be made available by the multilateral financial institutions can be expected to show considerable variations among DEEs according to their access limits and eligibility to different categories of financing. Of the \$250 billion SDR allocation DEEs would receive some \$80 billion of which less than a quarter should be available to low-income countries. These amounts are small fractions of estimated external financing needs of the developing world. Any additional IBRD lending funded by bond issues would not be available to a large number of poor countries, including those in low-income and lower-middle-income categories. On current rules additional IMF lending financed by bilateral and/or market borrowing should in principle be non-concessional. Judging on the basis of the established pre-qualification criteria, a very large number of DEEs, including several market-access countries with large current account deficits, high levels of public debt, high and unstable inflation etc. should not be eligible to the FCL.

It is generally agreed that when the balance-of-payments difficulties of a member of the Fund result from external shocks of a permanent nature, or from excessive expansion of domestic absorption, IMF financing should be accompanied by domestic policy adjustments to reduce the deficits. However, when payments difficulties are due to temporary external shocks, they need to be financed rather than reduced through policy adjustment. The current financial crisis appears to contain both permanent and temporary elements of change. It can be expected that the crisis will bring a durable adjustment to the external deficits of the United States resulting from the long-awaited consumer retrenchment. This certainly calls for an adjustment in surplus countries, including the Asian developing countries, notably China, but not resource-constrained DEEs.⁹ This means that deficit DEEs should not be subjected to pro-cyclical macroeconomic policy conditionality for any additional borrowing needed to meet their balance-of-payments shortfalls resulting from trade and financial shocks from the crisis. However, despite the “recent modernization of conditionality”, the Fund has continued to impose pro-cyclical macroeconomic tightening in almost all recent standby programs - fiscal tightening in Pakistan, Hungary and Ukraine, and interest rate hikes in Latvia and Pakistan (TWN 2009). Even though some of these countries may have had large budget deficits when they approached the Fund for loans, recessions are not the best times to undertake fiscal adjustment.

Nor should multilateral financing made available to DEEs to meet their balance-of-payments difficulties due to a global crisis of which they have no responsibility place a heavy burden on them. This means that a high degree of concessionality would be needed. Indeed the IMF had established two highly concessional oil facilities in the 1970s as deliberate countercyclical devices to prevent oil price hikes from triggering a global recession, with countries enjoying almost automatic access without counter-cyclical macroeconomic conditions.

Low-income countries should be compensated not burdened with additional debt and debt servicing because of financing they receive to meet the shocks from the crisis. For political reasons as well as effectiveness ODA grants are not the best way to achieve this. An

⁹ For implications of the current crisis for external adjustment in the United States and China see, Akyüz (2008a).

option would be to make a one-off permanent SDR allocation to these countries, based on some criteria of need.¹⁰ The cost of drawing on such allocations could be financed collectively from the IMF resources, including gold sales. This should be combined with a moratorium on servicing debt owed by these countries to official creditors, without any additional interest charges.¹¹

A no-cost SDR allocation to low-income countries can be combined with a large reversible SDR allocation to other DEEs, to be repurchased when the crisis is over, to provide them with low-cost, no-conditionality resources. Proposals for reversible SDR allocations were made in the 1990s in order to allow the IMF to act as a lender-of-last-resort for financial bailout operations in emerging economies hit by financial crises. The rationale for such an allocation is no doubt much stronger now given the sharp contraction in global output and trade.

A large and reversible SDR allocation would extend the policy of “quantitative easing” to the global level, widely used by some major economies in stabilizing conditions in domestic credit and financial markets and stimulating spending. Reversibility would also provide automatic exit, thereby preventing inflationary pressures once recovery is under way. Furthermore, relying mainly on SDR allocation to meet external financing needs would also help avoid several undesirable consequences of funding IMF lending with bilateral loans from its shareholders, discussed in the subsequent section. Finally, a large SDR allocation could allow surplus emerging economies such as China to diversify their reserve holdings and reduce their vulnerability to dollar instability.

The exact purpose and use of IMF lending under current conditions also need to be scrutinized. As in the past, the existing standby programs of the Fund appear to be premised on maintaining open capital accounts and ensuring that developing country debtors stay current on their payments to private creditors. Of all the countries with IMF stand-by programs, only Iceland has widespread capital controls over resident and non-resident outflows, introduced in the early days of the crisis. None of the emerging markets with IMF programmes has introduced similar measures despite continued capital outflows. Even though the Fund may no longer be actively promoting capital account liberalization, its aversion to restrictions seems to continue unabated.

There can be little doubt that the rationale for capital controls over outflows in countries facing severe balance-of-payments difficulties is much stronger than that for trade restrictions. However, the latter have proliferated both in DEEs and advanced economies after the outbreak of the credit crunch while capital accounts have remained largely open even in countries facing large and continued outflows.¹²

In such cases the Fund should not only support but also recommend use of temporary exchange restrictions, preventing the burden of adjustment falling disproportionately on trade. These restrictions should also include temporary debt standstills. It is true that the international community has not been able to establish orderly mechanism for the protection of debtors against litigation in such cases— an issue to be taken up in section D. But the IMF

¹⁰ For a discussion of SDR allocation to poor countries as a way of reducing costs of holding reserves see, Polak and Clark (2006).

¹¹ UNCTAD has also called for a temporary moratorium on official debt servicing by DEEs; see, UNCTAD (2009).

¹² On trade restrictions see, Gamberoni and Newfarmer (2009) and World Bank (2009).

can express its support by “lending into arrears”, thereby deterring potential hostile action by private creditors.

Such restrictions should also be applied in FCL - eligible countries if the precautionary access provided by the FCL fails to stem speculative attacks and there are large and persistent outflows. Outflows can indeed accelerate if emerging economies lag in recovery behind advanced economies. Borrowing from the IMF to finance such outflows could lead to considerable increases in government debt burden, particularly where an important part of foreign claims are on the private sector, as seen in Asia during the 1997 crisis. Besides, there are serious risks in the Fund acting as a lender-of-last-resort to any country - an issue discussed in section D. It would thus be prudent to take up this matter at some length in the context of broader systemic reform of the international financial architecture.

III REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

For DEEs there are two key issues in the reform of the international financial architecture. The first relates to crisis prevention: how best to reduce their vulnerability to international financial instability and crises while retaining adequate policy autonomy in determining the pattern and degree of their integration into world financial markets and managing capital flows and exchange rates. Prevention of crises with global repercussions requires addressing three major sources of instability: policies, markets and the current international reserves system centred on the dollar. More specifically it calls for:

- Effective multilateral discipline over financial, macroeconomic and exchange rate policies in systemically important countries;
- Establishment of an international reserves system not based on a national currency or currencies and;
- Effective regulation and supervision of financial markets and capital flows.

It should, however, be kept in mind that while effective multilateral arrangements are important for reducing the likelihood of crises with global spillovers, they cannot fully protect DEEs against instability and crises. They are not substitutes for national policies and institutions for crisis prevention. This makes it all the more important to retain adequate national policy space while setting up a new multilateral framework for the governance of international finance.

The second area of reform relates to crisis response. It is generally agreed that regardless of the measures that may be adopted to secure greater stability, crises with global ramifications will continue to occur. The damage they inflict on the world economy and its incidence will depend on policy responses at national and international levels. The current crisis shows that closer multilateral cooperation and tighter discipline are needed to ensure that national policy responses take into account their impact on other countries and to avoid negative international spillovers and beggar-my-neighbour policies. Even more importantly, there is a need to improve international interventions in the balance-of-payments, currency and debt crises in DEEs. This calls for, *inter alia*, a fundamental reform of the mandate, operations and funding of the IMF.

III.1 Areas of reform for crisis prevention

III.1.1 Multilateral policy discipline in money and finance

National policies almost always play a central role in financial instability and crises. Misguided deregulation of domestic financial markets, premature liberalization of the capital account, and unsustainable macroeconomic and exchange rate policies are often the proximate causes of currency and balance-of-payments instability and financial crises. This is true both for DEEs and advanced economies. However, global repercussions of financial

crises and currency instability in systemically important countries are much more serious than those in DEEs even though there is often regional contagion from crises in emerging economies, as witnessed in East Asia during 1997.

Boom-bust cycles in capital flows to developing countries and major international financial crises are typically connected to large shifts in macroeconomic and financial conditions in the major industrial countries. The sharp rise in the United States interest rates and the appreciation of the dollar was a main factor in the debt crisis of the 1980s. Likewise, the boom-bust cycle of capital flows in the 1990s which devastated many countries in Latin America and East Asia were strongly influenced by shifts in monetary conditions in the United States and the exchange rates among the major reserve currencies. (UNCTAD TDR 1998, Part II, chap. IV; and 2003, chap. II). This is even more visible in current conditions where the boom-bust cycle in the United States financial markets has produced the most serious post-war global financial and economic crisis.

It must now be evident that adverse international spill overs from macroeconomic, exchange rate and financial policies in advanced economies are much more damaging to DEEs than shocks from their trade policies. But unlike trade, there is no effective multilateral discipline in money and finance. The IMF members have the same *de jure* obligations to maintain orderly macroeconomic and balance-of-payments conditions and stable exchange rates. But the Fund's policy oversight is confined primarily to its poorest members who need to draw on its resources because of their lack of access to private finance and, occasionally, to emerging economies experiencing interruptions in their access to private financial markets. By contrast the Fund is totally unable to impose meaningful disciplines over the policies of its major shareholders who exert a disproportionately large influence on global monetary and financial stability.

There are problems regarding not only effectiveness and evenhandedness but also the quality of surveillance. After a series of crises in emerging economies the Fund's Interim Committee (now the International Monetary and Financial Committee, IMFC) agreed in April 1998 that the Fund should intensify its surveillance of financial sector issues and capital flows, giving particular attention to policy interdependence and risks of contagion (IMF 1998). However, the Fund's intensified surveillance over emerging economies was not able to prevent further crises in Argentina, Russia and Turkey, all operating at the time under Fund programmes, in large part because it failed to diagnose and act on the root causes of the problem. Indeed, according to an independent assessment of Fund surveillance, policy makers interviewed had important reservations regarding the quality of the Fund's analysis of capital account issues (IMF/GIE 1999: p. 13).

Similarly, in the run up to the present crisis the Fund failed to identify the nature and extent of potentially destabilizing speculative build-up and to provide adequate early warning. In its Article IV Consultations with the United States throughout 2005-06 the Fund staff was preoccupied with reducing fiscal and external deficits and maintaining control over inflation as the main policy challenges facing the United States economy, while reassuring that the "U.S. financial sector has proven exceptionally resilient in recent years." IMF (2005: p. 31; and 2006: p. 23). Even a month before the beginning of the credit crunch, the IMF staff argued that "the most likely scenario is a soft landing as growth recovers and inflation falls, although both are subject to risks." (IMF 2007a: p. 26). In the same month, July 2007, the IMF staff assessment of economic conditions in Iceland was also highly upbeat, maintaining that "Iceland's medium-term prospects remain enviable" while adding some caveats about

downside risks associated with large current account deficits, increasing indebtedness and high inflation (IMF 2007b: p. 17).

This failure in adequately assessing the risks of instability and providing early warning appears to be deep-seated in the belief of the Fund secretariat, encouraged by some of its major shareholders, that disequilibria and imbalances generated by freely functioning financial and currency markets are self correcting, without entailing severe social and economic costs of adjustment. It has an obsession with budget deficits and inflation as the main threats to macroeconomic stability and growth, ignoring that inflation in asset markets driven by speculative lending and investment, both nationally and internationally, tends to pose even greater threats, despite mounting evidence from recurrent crises in emerging and mature markets alike.

A key question is, therefore, how to overcome the problems regarding quality, effectiveness and evenhandedness of IMF surveillance. The G20 (2009c; para 12) expressed its support for “candid, even-handed, and independent IMF surveillance” without making specific recommendations as to how these could be achieved. Subsequently the IMFC reaffirmed the emphasis on “candor, even-handedness, and independence” and the need “to enhance the effectiveness of surveillance.” (IMF 2009c: para 11). However this has little credibility since the IMFC is known to have come up with similar pronouncements in almost every other meeting, particularly those held after episodes of instability in international currency and financial markets.¹³

There can be little doubt that problems regarding the quality, effectiveness and evenhandedness of IMF surveillance cannot be resolved without addressing its governance-related shortcomings. There is no ready-made solution and further reflection is needed on the ways and means of achieving these objectives. Given that the existing mechanisms within the Fund have so far failed to do so despite repeated pronouncements of intention, such a process should best be conducted outside the Fund.

A notable suggestion for improving surveillance, made by a senior British Treasury official, is its formal separation from decisions about program lending and the use of IMF resources so as to establish the Fund as independent from political influence in its surveillance of economies as an independent central bank is in the operation of monetary policy (Balls 2003). It is rightly argued that the current structure of the IMF treats program design as an extension of surveillance, but the lack of a clear distinction between lending and surveillance activities creates the wrong incentives and diminishes the effectiveness of surveillance. Moreover, there is currently no formal regular mechanism for assessing whether the Fund is providing objective, rigorous, and consistent standards of surveillance across all member countries – program and non-program countries. While responsible for ensuring the effectiveness of the Fund's activities, Executive Directors also have responsibilities to their authorities. This creates a conflict of interest where Executive Directors tend to collude in surveillance in defence of the countries they represent, turning peer pressure into peer protection. Surveillance should thus rest with authorities who are independent of their

¹³ For instance, in September 2000 the Committee emphasized “enhancing Fund surveillance, and promoting stability and transparency in the financial sector”: in April 2002 it encouraged the Fund “to press ahead with the range of recent initiatives designed to enhance the effectiveness of surveillance and crisis prevention, including the Financial Sector Assessment Program”: in October 2004 it allocated four paragraphs on “making surveillance more effective and strengthening crisis prevention”; and in April 2006 it proposed a “new framework for IMF surveillance” which included, *inter alia*, making the staff “accountable for the quality of surveillance”.

governments and who are not involved in lending decisions, making it impartial, legitimate, authoritative, transparent and accountable.

III.1.2 Stable international reserves system

A reserves system based on a national currency as a means of international settlement and a reserve asset suffers from a major dilemma. This was pointed out by Triffin (1960) almost half a century ago, questioning the viability of the Bretton Woods arrangements based on the United States dollar. In a dollar-based system net holding of dollar assets by the rest of the world depends on the United States running current account deficits. If the United States stopped running deficits, the shortage of international liquidity would stifle global trade, investment and growth. If, on the other hand, the United States runs growing deficits and supplies adequate liquidity to the world economy, the accumulation of liabilities could undermine the confidence in the dollar, depressing its value vis-à-vis other reserve assets - namely, gold under the Bretton Woods system. Restoring confidence and overcoming inflationary pressures would then call for United States interest rates to rise and deficits to fall, depressing economic activity and employment. Therefore, while issuing a reserve currency gives the country an advantage in financing its deficits, it can also become problematic. With the accumulation of liabilities abroad, the country can lose its monetary policy autonomy and be forced to adopt deflationary policies.

Indeed, the Bretton Woods system of exchange rates collapsed as the immediate post-war dollar shortage was translated into a dollar glut with the growing United States deficits, which made it impossible to maintain gold convertibility at a fixed rate, leading to a unilateral suspension in 1971 -the first and the most significant post-war default of international obligations by any country. The move to floating exchange rates, rapid growth of international financial markets and capital flows, and the rise of Germany and Japan as industrial powers did not challenge the dominance of the dollar. As explained by the IMF historian Boughton (2001: p. 937) Germany and Japan “were reluctant to see their currencies ‘internationalized’ and used as reserves ... Moreover, the prospect of a system of multiple reserve currencies was widely viewed, both inside and outside the Fund, as a potentially destabilizing development that was to be avoided if possible. If central banks held several different currencies, then they would be likely to shift the composition of their portfolios to optimize expected returns. Such speculation could magnify the effects of market shifts in confidence or in expected relative returns.” At the time of the suspension of gold convertibility, the estimated share of the dollar in all official reserves other than gold was 70 per cent, compared to around 65 per cent at present.

In the post Bretton Woods era instability in the United States balance-of-payments has continued unabated, even aggravated by the absence of effective multilateral discipline over its macroeconomic policies - a discipline that the Bretton Woods System had sought to establish through gold convertibility. This resulted in recurrent gyrations of the dollar vis-à-vis other reserve currencies and played a major role in increased global financial instability.

After the collapse of the Bretton Woods system, the need for reserves was expected to lessen as countries gained access to international financial markets and became more willing to respond to balance-of-payments shocks by adjustments in exchange rates. However, capital account liberalization in DEEs and their greater access to international financial markets has produced exactly the opposite result. International capital flows have no doubt

allowed running larger and more persistent current account deficits beyond the levels that could be attained by relying on international reserves. But this has also resulted in an accumulation of large stocks of external liabilities and growing presence of foreigners in domestic securities markets. The debtor countries have thus become increasingly vulnerable to sudden stops and reversals in capital flows, with grave consequences for stability, growth and development. This became increasingly visible after the Asian crisis in 1997 when the only collective insurance available, namely the IMF lending, proved to be highly unreliable and even counterproductive.

Thus, the combination of increased capital account liberalization in DEEs, accumulation of external liabilities, pro-cyclical behaviour of international financial markets, and the absence of effective multilateral arrangements for the provision of international liquidity and orderly debt workout procedures has forced DEEs to look for self-insurance by accumulating large stocks of international reserves, mostly held in dollars. While traditionally reserves covering three months of imports were considered adequate for addressing the liquidity problems arising from time lags between payments for imports and receipts from exports, it has become a common wisdom that in order to avoid a liquidity crisis, international reserves in DEEs should at least meet their short-term external liabilities.¹⁴

At the end of 2008 total international reserves of DEEs reached some \$5.5 trillion, or 7 months of imports. Even though DEEs taken together have been running current account surpluses in recent years, only about half of their total reserves are earned from current account surpluses, mainly by China and Fuel Exporters. The rest came from capital inflows - that is, they are borrowed reserves.¹⁵ In a few countries such as China, current account surpluses and reserve accumulation have been associated with rapid growth. But in a large number of DEEs additional reserves came either from capital inflows or from trade surpluses achieved by cutting growth for fear that a possible downturn in commodity prices or reversal of capital flows would necessitate additional international liquidity.

These reserves are invested in low-yielding assets, mainly the United States treasury bills and bonds. On the basis of average historical spreads between the borrowing rate and return earned on reserves, the annual carry cost of borrowed reserves alone to DEEs can be estimated to be in the order of some \$130 billion. This constitutes a net transfer of resources to reserve-currency countries, notably the United States, and exceeds total official development assistance to developing countries.¹⁶ The cost borne by DEEs would be greater if allowance is made for foregone growth by putting export surpluses into United States treasuries rather than investment and imports. Furthermore, DEEs could incur losses on their dollar holdings if the large build up of United States government liabilities resulting from bailout and fiscal stimulus packages were to produce inflation and dollar depreciation.

Both the G20 summit and the IMFC remained silent on reform in this key area. There are various options in establishing an international reserves system not based on national

¹⁴ This is known as Guidotti-Greenspan rule formulated after the Asian crisis. For a discussion of adequate level of reserves see UNCTAD TDR (1999; chap. V).

¹⁵ Borrowed" in the sense that they accompany increased claims by non-residents in one form or another, including direct and portfolio equity investment, which entail outward income transfers.

¹⁶ The method used here to estimate reserve costs differs from that in the literature in that a distinction is made here between borrowed and earned reserves. Polak and Clark (2006) also refer to borrowed reserves in their estimation of the cost to poorest developing countries.

currencies so as to avoid these difficulties. One proposal is to go back to the gold standard. Another is to revisit Keynes's proposal, made at the Bretton Woods Conference, of introducing a global currency, *the bancor*, exchangeable with national currencies at fixed rates, issued by a global central bank - the International Clearing Union - to provide countries liquidity for international payments clearance as well as overdraft facilities by amounts based on the value of their trade.¹⁷ However, building on existing mechanisms and institutions and a gradual move away from the dollar towards the SDR (or expanded SDR) appears to be a more practical solution.

An important advantage of SDRs, particularly for DEEs, is that unlike dollar reserves, holding SDRs does not entail costs; cost is incurred only when they are used. Under present arrangements the IMF may allocate SDRs to members in proportion to their quotas. Members obtain or use SDRs through voluntary exchanges or by the Fund designating members with strong external positions to purchase SDRs from those with weak external position. When members' holdings rise above or fall below their allocation, they earn or pay interest respectively, with the interest rate being determined as the weighted average of interest rates on short-term debt in money markets of the SDR basket currencies.

The cost advantage of SDRs has given rise to calls for regular distribution to alleviate the burden of holding reserves on low-income countries. Indeed, a former Director of Research of the IMF, Jacques Polak, argued in a joint paper that the only principle that should now guide the allocation of SDRs should be "the benefits of permitting low-income countries to acquire and hold reserves at a much lower interest rate than they would have to pay in the market and a reduced dependence of the system on borrowed reserves that are liable to be recalled when they are most needed."¹⁸

Regular allocations of SDRs on the basis of existing rules cannot promote the SDR to be a major reserve asset and address the inequities and instability resulting from the current system based on national currencies, even if such allocations are done more often than have been the case. A way forward is to make the IMF an SDR-based organization, and to allow SDRs to replace quotas and GAB and NAB as the single source of funding for the IMF. The Fund could be permitted to issue SDRs to itself up to a certain limit which should increase over time with growth in world trade. Under such a scheme the present practice of allocations to countries according to their quotas would be discontinued. Unconditional access limits (the so-called reserve tranche or gold tranche) would need to be redefined and widened considerably based, *inter alia*, on some criteria of need.

In such an arrangement the demand for SDRs (or drawings from the IMF in SDRs) can be expected to be inversely related to buoyancy in world trade and income and the availability of private financing for external payments. Thus, allocations could be altered in a procyclical way, accelerated at times of global slowdown. This would help counter

¹⁷ For a recent discussion of this proposal in relation to the current crisis see, Monbiot (2008). Ironically this proposal is now revisited for addressing the problems associated with the dollar-based reserve system and the United States indebtedness while at the Bretton Woods it was opposed by the very same country because it was the biggest creditor at the time and Keynes was proposing taxing current account surpluses. By contrast, in a recent speech on *Reform of the International Monetary System*, proposing adoption of the SDR as a global reserve currency, the governor of China, the country with the biggest surplus, referred to Keynes's *bancor* proposal as "farsighted"; see, Zhou (2009).

¹⁸ See Polak and Clark (2006) which also addresses whether SDRs should be issued to all members or to low-income countries alone.

deflationary forces in the world economy and provide an offset to fluctuations in private balance-of-payments financing.

Several issues of detail would still need to be worked out, but once an agreement is reached to replace traditional sources of funding with the SDR, the IMF could in fact be translated into a technocratic institution of the kind advocated by Keynes during the Bretton Woods negotiations. Its funding would no longer be subjected to arduous and politically charged negotiations dominated by major industrial countries. Nor would it need to borrow from some of its members in order to lend to others. Such an arrangement could thus bring a considerable improvement to the governance of the IMF, allowing it to stay at equal distance to all its members and help to perform policy surveillance even-handedly and effectively.

Making the Fund an SDR-based institution would no doubt result in a considerable increase in the supply of SDRs compared to the existing stock or the growth that could be expected under current practices. It would allow major surplus countries to invest their reserves in SDRs instead of reserve currencies. It is also possible to supplement this with a mechanism to remove the dollar overhang by allowing countries to rapidly replace their existing stocks of dollar reserves with SDRs without causing disruption in currency markets. Such a proposal was made by the Governor of the People's Bank of China. According to this proposal the IMF would "set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired" (Zhou 2009).

This proposal corresponds to what came to be known as the substitution account, extensively discussed in the IMF in two previous episodes of considerable dollar weaknesses, but abandoned for several reasons; first, in the early 1970s in the Committee of 20 in an effort to replace the Bretton Woods system by something more viable, and then in the late 1970s and early 1980s as the dollar weakened considerably.¹⁹ The idea is a simple one: the IMF would issue interest-bearing certificates denominated in the SDR against dollar reserves handed over by central banks at the market exchange rate, and invest these reserves in interest-bearing United States treasury bills and bonds. The operation would not affect the total volume of international reserves but its composition – thus no "inflation" fears. Countries can use these certificates to settle international payments or to acquire reserve currencies. The substitution would result in a withdrawal of a large stock of dollar reserves from the market and put them into IMF coffers. It would eliminate the risk of monetary turmoil that could result from a potential widespread unloading of dollar reserves by central banks.²⁰

Several issues of importance to DEEs would need to be sorted out.²¹ First and foremost, there is the question of who will bear the exchange rate risk. A change in the dollar/SDR exchange rate would create losses and gains for the IMF since, by definition, a substitution account would mean a currency mismatch between assets and liabilities. A sustained decline in the dollar against other currencies that make up the SDR will imply losses. The exposure of the Fund can be considerable if the account is open-ended, rather

¹⁹ For an account of these deliberations see, Boughton (2001: pp. 936-43). See also Bergsten (2009)

²⁰ Kenen (2005) suggests that a widespread unloading of dollar reserves into euro could be absorbed by establishing a similar substitution account at the European Central Bank so as to avoid undesirable effects of a flight from the dollar on interest rates and exchange rates.

²¹ These are discussed in Boughton (2001, 2007) and Bergsten (2007a, 2007b).

than restricted in size. There is no guarantee that interest differentials between the dollar and SDR would provide cover for such losses.²² This is true whether the interest on SDRs is calculated as at present, or set in the market established for the SDR.

In the previous discussions of this proposal, the IMF gold was proposed to be used for cover. But this would mean pushing the losses onto all members of the Fund, rich and poor alike. If, on the other hand, the exchange rate risk were to be borne by holders of the SDRs, the operation would be meaningless - there would be no incentive for holders of dollar reserves to subscribe to the account. An alternative would be for the United States to bear the risk - that is, to supply more interest-bearing dollar assets to cover exchange losses if the dollar falls against the other currencies. A more equitable solution would be to share the risk between the United States and the Central Banks subscribing to the substitution account, rather than pass it onto the Fund, including its poorer members.

A second issue relates to the privatization of the SDR. Establishing a private market for SDRs by allowing banks to hold them, and using them in currency interventions would certainly improve its liquidity and status as a reserve asset. This is also seen as necessary for the substitution account to be attractive to central banks, not only in replacing dollar reserves but also reserves held in other currencies, including potential ones such as the Chinese yuan. However, this could also make the SDR a new instrument of speculation and a source of instability. In other words, it might be difficult to reconcile a high degree of liquidity with stability of its exchange value. It is therefore important to strike the right balance between the two and to ensure that SDRs are used mainly for settlements of payments linked to international trade and investment.

III.1.3 Regulation of international financial markets and capital flows

Past experience shows that even when monetary and fiscal discipline is secured and a relatively high degree of price stability is attained, unbridled financial markets are capable of generating instability and crises with serious consequences for the real economy, notably jobs and incomes. The global financial turmoil triggered by the sub-prime debacle has shown once again that the Anglo-American view that financial markets regulate themselves is not only wrong but is also highly damaging.

There is now a broad agreement on the need for tighter regulation than has been the case, but views differ about how best to regulate and the degree of regulation. Moreover, regulation of international capital flows is highly contentious. The dominant view still entertained in the mainstream is that once financial markets and institutions are properly regulated there is no need to restrict international capital flows. However, this does not stand against ample evidence that prudential rules do not necessarily bring greater stability to international capital flows, nor can they prevent such flows from inflicting serious damage on an economy (Akyüz 2008b).

Several reasons are usually given why financial regulation should be international. First, since financial instability often has adverse global spill overs, national regulatory practices should be subject to multilateral disciplines. Second, multilateral rules would provide a level playing field and prevent regulatory arbitrage – that is, business running away from tightly to

²² An alternative would be for the IMF to invest dollar reserves into long-term Treasury bonds which normally carry higher interest rates. But this would not necessarily cover the exchange rate losses.

lightly regulated jurisdictions. Finally, they would reduce the influence of politicians over regulators and give them a certain degree of independence – a concern that is now widely shared after the hands-off approach that the previous United States administration had adopted vis-à-vis financial markets.

While these considerations are basically valid, there are both political and technical difficulties in establishing multilateral discipline in financial regulation and supervision. A supreme international body with fully-fledged regulatory and supervisory powers over all financial institutions is not on the agenda. However, it is increasingly held that global and systemically important institutions should be regulated and supervised internationally rather than nationally. Several proposals have been made for establishing international bodies for credit rating agencies and transnational banks over a certain size.²³

An option would be to leave the conduct of regulation and supervision to national authorities within a framework established according to the same principles as the WTO.²⁴ This would involve binding multilateral agreements on a set of rules and regulations for financial institutions including banks, institutional investors, rating agencies, and bond and credit insurance companies. There would be a commitment by governments to implement such rules and regulations through national regulators. Finally, there could be a multilateral body to oversee implementation and impose sanctions for non-compliance, such as denying access of financial firms from non-complying countries to markets of other members.

However, it is still quite unrealistic to expect systemically important countries, including some emerging economies, to give up national policy autonomy to the extent required. It is notable that even the EU has not managed to establish a unified regulatory system. Furthermore, serious difficulties could be faced in reconciling and integrating different legal systems and conceptual frameworks in arriving at a uniform set of rules for economies at different levels of financial development and with different financial institutions and culture.

More importantly, such an arrangement would carry risks and drawbacks for DEEs. It is not realistic to envisage that a global institution with genuine clout over major advanced economies could be established on the basis of a distribution of power markedly different from that of existing multilateral financial institutions. Thus, it may not be wise to create another multilateral body before solving satisfactorily the governance-related problems that pervade the existing institutions such as the IMF, WB and WTO.

Second, there is the familiar one-size-fits-all problem. In all likelihood, rules and regulations to be agreed in such a setting would be shaped by the exigencies of financial markets and institutions of more advanced economies. These would not always be suitable to

²³ Several authors in Eichengreen and Baldwin (2008) propose a single global regulator for large highly leveraged institutions and banks with significant border-crossing activities.

²⁴ A proposal made after the Asian crisis was to establish a World Financial Authority (WFA) or to turn the BIS into such a mega-agency “with major powers to establish best practice financial regulation and risk management throughout international financial markets... to enforce regulatory standards, backed by high-profile surveillance ... [and] monitor and mediate the imposition of capital controls by national governments”; see, Eatwell and Taylor (1998). For a more detailed discussion see, Eatwell and Taylor (2000) and for an assessment, Akyüz and Cornford (2002).

DEEs. On the other hand, as the experience in the WTO shows, special and differential treatment that may be granted to DEEs may not mean much in practice.²⁵

Furthermore, entering into comprehensive multilateral negotiations could open the Pandora's Box of market access in financial services, liberalization of capital flows and multilateral agreement on FDI, resulting in further restrictions over policy space in DEEs. The real danger for DEEs is that a process designed to broaden the scope of global governance over finance may end up extending the global reach of financial markets. It is notable that one of the recommendations of a G20 working group on international cooperation was for Financial Stability Forum (FSF) member countries to "maintain the openness of the financial sector" (G20 2009a: p. 7). It is not clear if this is meant to be liberalization of market access in financial services or if it would apply to new developing-country members of the expanded FSF. But it is a clear sign that global arrangements for financial regulations may entail new obligations for DEEs for opening up their financial sectors to foreign firms.

A less ambitious approach would be to extend the mandate and improve the governance of existing bodies such as the FSF, the BIS, the Basle Committee on Banking Supervision, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions. Most existing proposals for improving global governance of finance indeed envisage a voluntary process of closer coordination among national regulators, based on an agreed framework within such institutions, rather than a rules-based system with sanctions.²⁶

The G20 also appears to be moving in that direction, emphasising the need for "internationally agreed high standards", "common and coherent international framework, which national financial authorities should apply in their countries consistent with national circumstances" and "systematic cooperation between countries"²⁷ It proposes "to establish supervisory colleges for all major cross-border financial institutions" (G20 2009a: p. 5). The Group has also agreed to transform the FSF into a Financial Stability Board by extending its membership to include all G20 countries and its mandate to the regulation and oversight of all systemically important financial institutions, instruments and markets, including the hedge funds and credit rating agencies.

There are also proposals to give a greater role to the IMF in financial surveillance. However, this role should not be extended to setting regulatory standards or overseeing financial markets and institutions. In this area the task of the Fund is to monitor macroeconomic and financial developments and provide early warning of risks of instability and crises. Its ROSC (Report on the Observance of Standards and Codes) exercises, introduced after the Asian crisis and undertaken as part of Article IVC consultations and in conjunction with the joint FSAP (Financial Sector Assessment Program) activities with the

²⁵ Eichengreen (2008) proposes the creation of a World Financial Organization where members would undertake obligations for regulation and supervision set out in its charter and agreements, but would be free in how to meet them. This would permit regulations to be tailored to the structure of individual financial markets. An independent body of experts would then decide whether the members have met their obligations, imposing sanctions such as denying access of banks from non-complying countries to the markets of other members. However, such a loose arrangement without clearly defined rules and obligations may not provide adequate safeguards for DEEs, or prevent regulatory arbitrage.

²⁶ See e.g., G30 (2008) and proposals made in several papers in Eichengreen and Baldwin (2008).

²⁷ G20 (2009b: para 4; and 2009c: paras 13-15).

World Bank are meant to help promote global financial stability. However, these activities have been highly ineffective because of several shortcomings in the design and application of codes and standards.²⁸ Therefore, before the IMF may be given new roles in the financial architecture, it is important to have a reasonably good understanding of the factors that have made existing instruments and mechanisms ineffectual and to remove them through appropriate reform.

A possible guiding principle for DEEs in the reform of the global financial architecture in the area of financial regulation and supervision could be to allow and retain considerable autonomy in setting standards for financial institutions without significant border-crossing activities. A multilateral framework for national regulatory systems or global regulators should be introduced only for transnational financial institutions. The nature and extent of regulations of different transnational financial activities and institutions needed is a highly complex issue that would require considerable deliberations. Even where developing countries do not have transnational financial institutions, they should have voice in setting global rules and standards since they often do business with those from advanced economies. For instance, supervisors from DEEs should always participate in supervisory colleges proposed by the G20, rather than being invited to such bodies as host supervisors “where appropriate”, as envisaged by a G20 working group (G20 2009a: para 4).

In the regulation of transnational financial institutions, the main objective of DEEs should be to ensure that the proposed mechanisms address their vulnerability to external financial instability and shocks. This calls for attention to at least the following areas:

First, international lenders to DEEs behave in a highly pro-cyclical way and this increases their susceptibility to external shocks. At times of boom, they lower their standards in lending to financial and non-financial firms in developing countries, and governments are not always fully able to prevent such surges creating serious currency and maturity mismatches in private balance sheets. When the times change and risk assessment takes a downturn, lending is rapidly withdrawn, often leading to currency collapses and widespread bankruptcies, with the state often taking over private liabilities. Therefore, the main interest of DEEs is the much emphasized and fashionable counter-cyclical prudential measures for international banks is their potential impact on pro-cyclical behaviour in international lending.

Second, governments and private firms in DEEs face similar difficulties when they borrow abroad through international security issues. Rating agencies are not only pro-cyclical but are also biased against borrowers from DEEs. Before the outbreak of the sub-prime credit crunch, ratings of many Asian emerging economies with sound payments, reserve and fiscal positions were below those of some advanced economies with serious vulnerabilities on these fronts - e.g. Iceland. Therefore, removing the rating bias and pro-cyclical behaviour should be the primary objective of DEEs in regulating international rating agencies.

Third, DEEs are not only borrowers from international markets. They are also investors in securities issued in advanced economies by both public or publicly sponsored institutions and private firms. Several Central Banks in DEEs are known to have invested large amounts in debt issued by the United States Government Sponsored Enterprises, including mortgage firms Fannie Mae and Freddie Mac. Again, the so-called toxic assets issued by private financial institutions have found their way into the portfolio of banks and institutional

²⁸ For these shortcomings see Cornford (2001), Schneider and Silva (2002) and Schneider (2005).

investors in DEEs. In fact, because of increased liberalization of capital outflows by residents, such exposure has been on the rise. Therefore, DEEs have a growing stake in greater transparency and objective assessment of quality of such securities. This calls for an overhaul of accounting, regulatory and underwriting standards and a fundamental reform of rating agencies. A Global Financial Products Safety Commission may also be established for this purpose with equal and full participation of DEEs.

Fourth, a growing source of instability of capital flows in developing countries is due to international portfolio investors, including institutional investors and highly-leveraged institutions, notably hedge funds. The task of delimiting the nature and extent of their operations within their borders naturally falls on national governments and regulators. However their task would be greatly facilitated by increased transparency of investors. The minimum requirement is registration with national financial authorities. Access to information on the degree and nature of leverage, the size and composition of portfolios and investment strategies of these investors would also be highly important for financial authorities in DEEs to make a reasonably sound assessment of the risks entailed by their entry into domestic asset markets.

III.2 Crisis intervention and resolution

Regardless of measures that may be taken to discipline policies in systemically important countries and to regulate systemically important financial institutions, instruments and markets, it is almost a certainty that crises will continue to occur. For countries which do not enjoy reserve currency status, notably the DEEs, balance-of-payments and debt crises will also continue to necessitate international interventions, except where there are effective regional alternatives. Under current arrangements this task falls on the IMF.

However, there are several contentious and unresolved issues regarding IMF interventions in crises in emerging economies, including their objectives, funding and policy conditionality. Considerable dissatisfaction was expressed by several developed and developing countries in the way interventions were designed and implemented in the late 1990s, and several proposals were made, both within and outside the Fund, for improvement (Akyüz 2005). But these were put aside as a result of opposition from its major shareholders and the complacency created by quick resumption of growth in most countries hit by financial crises and a strong recovery of capital flows in the early years of this decade.

The Fund's crisis intervention in the past typically involved injection of liquidity designed to keep countries current on their debt payments to private creditors, to maintain capital account convertibility and to prevent default, accompanied by monetary and fiscal tightening to restore confidence. Rescue packages amounted to several times the accepted quota limits and were often combined with bilateral contributions from major industrial countries. As noted, recent interventions do not diverge in a significant way from this pattern: capital accounts are kept open despite rapid outflows and depletion of reserves, policy conditionality continues to be pro-cyclical and the IMF is increasingly relying on funds borrowed from its main shareholders.

This approach is troublesome for several reasons. Pro-cyclical policies add to contractions in economic activity brought about by external trade and financial shocks,

leading to increased unemployment and poverty. Relying on major shareholders for funding increases their influence in the design of IMF programmes and even allow them to pursue their national interests, as observed in Korea during the 1997 crisis. More importantly, bailouts undermine market discipline, create moral hazard and encourage imprudent lending since creditors and investors are not made to bear the consequences of the risks they take. They shift the burden of the crises almost entirely onto debtors, particularly governments in DEEs which are often compelled to assume external liabilities of private debtors which can no longer service their debt. Moreover, the financial integrity of the Fund is jeopardized, particularly as scale of operations increases with rapid growth in cross-border lending and investment.

As these problems became increasingly visible in IMF interventions in recurrent crises in the 1990s and early 2000s, a proposed solution was to bail-in or involve international creditors and investors in the resolution of financial crises and to restrict IMF lending in order to encourage it. This received support from some G7 countries such as Canada, England and Germany. Various voluntary and involuntary schemes were proposed to achieve this, including temporary debt standstills and exchange controls. The IMF Board recognized that “in extreme circumstances, if it is not possible to reach agreement on a voluntary standstill, members may find it necessary, as a last resort, to impose one unilaterally”, and that since “there could be a risk that this action would trigger capital outflows ... it might be necessary to resort to the introduction of more comprehensive exchange or capital controls”, with the Fund signalling its “acceptance of a standstill imposed by a member ... through a decision ... to lend into arrears to private creditors.”²⁹

The Fund secretariat was also moving towards establishing a formal mechanism for involving private creditors in the resolution of sovereign debt crises through a Sovereign Debt Restructuring Mechanism (SDRM). Countries facing severe balance-of-payments and sovereign debt difficulties were envisaged “to come to the Fund and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling with its creditors, given the Fund=s consent to that line of attack. During this limited period ... the country would have to provide assurances to its creditors that money was not fleeing the country, which would presumably mean the imposition of exchange controls for a temporary period of time” (Krueger 2001: p. 7). However, because of opposition from its major shareholders and financial markets and lack of strong support from some developing countries, this proposal was first diluted – considerable leverage was granted to creditors and provisions for standstills were dropped – and subsequently abandoned altogether.

In response to the adverse impact of the crisis on trade and capital flows in DEEs, the international community has now chosen to establish a new facility, the FCL, to allow the Fund to lend large amounts of liquidity to certain countries deemed eligible on the basis of some pre-determined criteria. However, this has not been accompanied with measures to meet the consequent risks of moral hazard, unequal burden sharing and potential threat to the financial integrity of the Fund. The latter is a particular cause of concern since the majority of Fund members are excluded from access to this facility. This makes it all the more important to establish parallel arrangements to involve private creditors and investors in the resolution of balance-of-payments and debt crises in emerging economies.

²⁹ For the discussion of this issue in the IMF see, Akyüz (2005: pp. 9-15).

A central component of such arrangements is the recognition of the rights of countries facing large and sustained capital outflows to impose temporary debt standstills and exchange controls, and the provision of statutory protection to them in the form of a stay on litigation. The decision for a standstill should be taken unilaterally by the country concerned and sanctioned by an independent panel rather than by the IMF because the countries affected are among the shareholders of the Fund which is itself also a creditor. There can be little doubt that countries will resort to standstills with considerable prudence and discretion. As noted by a former Deputy Governor of the Bank of England, a “well-articulated framework for dealing with sovereign liquidity problems ... would be no more likely to induce debtors to default than bankruptcy law is to induce corporate debtors to default” (Clementi, 2000).

The Fund lending should focus on current account transactions, and there should be limits to lending to countries experiencing large and persistent capital outflows – notwithstanding that money is fungible and in practice it is not always possible to clearly identify the need catered for by a particular loan. Lending at progressively higher (penalty) rates, as the Fund now seems to be practicing, may not dampen the demand for liquidity from the FCL-eligible countries. Instead, the Fund should encourage involvement of private creditors by recommending and even requiring use of temporary standstills and exchange controls where needed.

Such restrictions should be introduced whether payments difficulties have their origin in private or sovereign debt or rapid exit of foreign investors; and whether they are due to liquidity or solvency problems - a distinction which is not always clear-cut. In cases of strong signs of insolvency, limits on IMF lending should be tighter - that is, countries should not borrow from multilateral sources to finance unpayable debt to private creditors, as happened extensively during the debt crisis in the 1980s (Sachs 1998: p. 53).

Because of absence of a multilaterally agreed legal system for debt workouts, the practice tends to be disorderly and ad hoc, and tends to favour creditors. Very often the IMF is involved in coordinating and resolving debt servicing difficulties, be it due to solvency or liquidity problems, based on an adjustment program agreed with the debtor country. The Fund generally seeks a voluntary agreement with creditors, but its position is asymmetrical - while it has a significant leverage vis-à-vis sovereign debtors it cannot impose appropriate terms and conditions on creditors. Even in bond contracts with collective action clauses (CACs), bondholders can hold out and opt for litigation in search of a better deal. Such ad hoc restructuring has rarely secured sustainability where there were problems of solvency. In cases where debt servicing difficulties were due to liquidity shortages, it provided relief through maturity rollover at penalty rates, but this often came very late in the crisis and failed to prevent the damage.³⁰

Multilateral arrangements for orderly workouts for sovereign debt should be efficient in that they should seek to contain the damage inflicted by debt servicing difficulties on the debtor and allow rapid recovery and growth, as in national bankruptcy procedures in many advanced economies, such as Chapter 11 of the United States Bankruptcy Code. They should also be fair in the distribution of the burden, making creditors bear the full consequences of the risks they have taken - risks which have already been compensated by handsome premiums. To the extent possible, debt restructuring including rollovers and write-offs should be based on negotiations between the debtor and creditors, and facilitated by the introduction

³⁰ For a discussion of Fund-led debt restructuring in emerging market crises see Akyüz (2002).

of automatic rollover and CACs in debt contracts. However, impartial arbitration is needed to settle disputes in the case of failure to reach agreement over the terms of restructuring.

Existing procedures for official debt workouts also need a fundamental change. Decisions on restructuring such debt are currently left to a club of creditors - the Paris Club - and are tied to IMF structural adjustment programs and sustainability assessments. Sustainability is often judged on the basis of how much debt and debt servicing a country can tolerate without adequate attention to its implications for development and poverty. Furthermore, political considerations often dominate debt-relief outcomes. It might be highly desirable to delink official debt restructuring from the IMF, and leave debt sustainability analysis to an independent body of experts, appointed with the consent of the debtors. The Fund, the Bank and United Nations agencies could provide inputs to this process in their respective areas of work. Debtor countries should also be allowed to submit their own analyses of sustainability. Consideration should also be given to establishing impartial arbitration for official debt disputes along the lines of Chapter 9 of the United States Bankruptcy Code which deals with public debtors and applies the same principles as Chapter 11.³¹

³¹ For the rationale of an international chapter 9 insolvency see, Raffer (1993).

IV SUMMARY OF POLICY CONCLUSIONS AND PROPOSALS

IV.1 Immediate policy response

- a. DEEs should not incur heavy burden in order to respond to fallouts from a crisis they cannot be held responsible for.
- b. DEEs facing payments constraints should not be denied the right to use legitimate trade measures in order to mitigate the impact of the crisis on jobs, incomes and poverty. Such actions should not be put in the same pot as import restrictions and subsidies introduced in advanced economies not facing similar constraints.
- c. DEEs should be encouraged to use temporary capital account restrictions and debt standstills in order to stem large and sustained outflows of capital. These should be supported by the IMF, where necessary, through lending into arrears.
- d. Any additional financing the DEEs may need in order to respond positively to shocks from the crisis should be unconditional, non-debt creating and/or at low-cost. This can best be achieved by SDR allocations rather than grants or IMF lending funded by bilateral borrowing from its shareholders:
 - A one-off permanent SDR allocation to low-income countries based on their need, with the interest costs of withdrawals being financed internally by the IMF.
 - A large reversible SDR allocation to other DEEs.
- e. There should be a moratorium on debt servicing by low-income countries to official creditors, including the Bretton Woods Institutions, at no additional costs.

IV.2 Crisis prevention: Multilateral policy surveillance

- a. There is a need to significantly improve the effectiveness, even-handedness and the quality of IMF surveillance over macroeconomic, financial and exchange rate policies. This is needed to secure greater multilateral discipline over policies in systemically important countries and bring greater coherence between trade and finance in this respect. Improvements are also needed to provide early warning for risks of macroeconomic and financial instability.
- b. Meeting these objectives depends very much on addressing the governance-related shortcomings of the Fund. Current arrangements suffer from a conflict of interest whereby Executive Directors pass judgement on surveillance of policies of the countries they represent. A solution could be formal separation of surveillance from lending decisions, entrusting it to an independent body.

IV.3 Crisis prevention: International reserves system

- a. The current multiple-currency reserves system centred on the dollar is highly unstable. It is very costly for DEEs which are compelled to hold large amounts of reserves as self insurance at the expense of growth and development. It should be replaced by a system not based on national currencies.
- c. An SDR-based reserve system appears to be the most viable option. This calls for fundamental changes in current arrangements regarding the allocation and use of SDRs.
- d. A way forward is to make the IMF an SDR-based institution by allowing it to allocate SDRs to itself to replace quotas, GAB and NAB and to become the only source of funding. This would also improve the governance of the IMF by removing its dependence on major countries for funding. SDR allocations could be linked to growth in world trade in a countercyclical manner. Under such an arrangement non-conditional access limits should be redefined and widened significantly.
- e. This could be supplemented with an arrangement to allow existing reserve currency holdings to be replaced with SDRs without causing disruptions in currency markets. This can be done through a substitution account at the IMF, extensively discussed in two previous episodes of significant dollar weaknesses in the early 1970s and 1980s.
- f. However, care should be taken in following this course, particularly to ensure that the exchange rate risk does not fall on the IMF including its poor members; and that the SDR does not become a new instrument of speculation.

IV.4 Crisis prevention: Regulation of international financial markets

- a. The principle that could guide the approach of DEEs to regulation of financial institutions, markets and instruments could be to retain sufficient domestic policy autonomy while seeking to reduce their vulnerability to instability and crises through regulation and supervision of transnational players with border-crossing activities.
- b. A supreme international body with fully-fledged regulatory and supervisory powers is neither realistic nor desirable. This is also true for replicating WTO in the area of finance, with binding multilateral agreements on rules and standards to be applied by national governments and sanctions for non-compliance.
- c. Such an arrangement could entail serious loss of autonomy and lead to one-size-fits-all. Moreover, there is the risk that the process designed to broaden the scope of global governance over finance may end up extending the global reach of financial markets, forcing DEEs into granting greater market access in financial services than would be appropriate.
- d. In assessing various proposals for regulatory reform of global financial institutions and markets, DEEs should pay attention to what these proposals could offer in reducing their vulnerability by:
 - Reducing pro-cyclicality in international bank lending to DEEs;

- Reducing the bias against DEEs and pro-cyclicality in ratings by international rating agencies;
 - Improving the quality of assets in which DEEs invest their reserves and private savings;
 - Improving the information on international portfolio investors in DEEs.
- e. DEEs should also resist giving the IMF a greater role in financial surveillance and monitoring before undertaking a thorough examination of the reasons why its ROSC and FSAP activities have been highly ineffective and removing them through appropriate reforms.

IV.5 Crisis intervention and resolution

- a. In providing international liquidity the Fund should not impose structural conditions; nor should it insist on macroeconomic policy adjustments when payments imbalances are due to temporary external shocks beyond the control of the borrowing country.
- b. IMF bailouts of international lenders and investors in countries facing rapid exit of capital undermine market discipline, encourage imprudent lending, shift the burden onto debtors and threaten the Fund's financial integrity. The IMF should not finance large and sustained capital outflows, but encourage involving private creditors and investors in the resolution of balance-of-payments and debt crises in emerging economies.
- c. The rights of countries experiencing large and sustained capital outflows to exercise temporary debt standstills and exchange controls should be recognized; and they should be granted statutory protection in the form of stay on litigation.
- d. To the extent possible restructuring of sovereign debt should be based on negotiations with private creditors and facilitated by inclusion of rollover and collective action clauses in debt contracts. But an international system of impartial arbitration is needed to settle sovereign debt disputes.
- e. Sustainability analyses in official debt restructuring exercises should be taken from the IMF and given to an independent body of experts. Consideration should be given to introducing arbitration for the restructuring of official debt of DEEs.

IV.6 Further areas of reform of the IMF

- a. Several of the above measures needed for reducing the likelihood of financial crises with global repercussions and ensuring better crisis intervention call for fundamental changes in the IMF. There are also additional reforms that need to be undertaken, particularly in its governance and mandate, in order to enhance its effectiveness and relevance.
- b. There has been considerable debate on the shortcomings in the Fund's governance in several areas including the selection of its head, the distribution of voting rights,

transparency and accountability, and no further remarks would be needed here. However, it should be emphasised that reforms at least in two areas discussed above may produce significantly greater improvement in the governance of the Fund than changes in areas emphasized in public debate:


- Ending the dependence of the IMF on its shareholders for funding through quotas and bilateral lending (GAB and NAB) by translating it into an SDR-based institution.
 - The separation of surveillance from program lending and giving the task to authorities who are independent of their governments and who are not involved in lending decisions.
- c. The Fund needs to focus on its main responsibility of safeguarding international monetary and financial stability. Consequently:
- It should stay out of development finance and policy and poverty alleviation. This is an unjustified diversion and an area that belongs to multilateral development banks. All facilities created for this purpose should be transferred to the World Bank as the Fund terminates its activities in development and long-term lending.
 - It should also stay away from trade policies. Its attempts to promote unilateral trade liberalization in DEEs drawing on its resources undermine the bargaining power of these countries in multilateral trade negotiations. In this area its main task is to ensure a predictable global trading environment by helping secure stable payments positions and exchange rates.

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