Making the international financial architecture work for development

Division on Globalization and Development Strategies

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Main messages

• With tepid recovery in developed countries and headwinds in many developing and transition economies, the crisis is not over and the risk of a prolonged stagnation persists.

• Insufficient demand in developed economies, combined with financial fragility and instability and with growing inequality, are the main constraints.

• To improve global growth and financial stability, and to realize the investment push required to attain the new development agenda, the systemic problems of the international financial architecture need to be addressed.

• Solutions are available – but need dedicated action by the international community.
Reforming the international monetary system

• International financial instability reflects the shortcomings of an international monetary and financial system where official financial sources have been overwhelmed by pro-cyclical private international liquidity which follows economic conditions in developed countries rather than financing needs in developing and transition economies.

• A number of national policies can increase resilience:
  – International reserves accumulation provided valuable but limited self-insurance to developing countries.
  – Exchange-rate management: managed floating
  – Capital-account management as part of ordinary policy toolkit
  – Reduce debt denominated in foreign currency by debt denominated in domestic currency

• But need for effective global measures to make the international financial system fulfill its three basic functions: providing sufficient liquidity; mitigating shocks and managing smooth adjustments, with a balanced contribution by surplus and deficit countries; providing long-term stable development finance.
Features of the current dollar standard and alternative reform proposals

- Supporting (more) symmetric adjustment
- Facilitating recovery from 2008–2009 crisis
- Maintaining purchasing power of foreign-exchange reserves
- Supporting exchange-rate stability
- Enabling orderly adjustment to external shocks through predictable and orderly supply of official international liquidity
- Efficient provision of official international liquidity through network effects
- Reducing need for foreign-exchange reserves
- Respecting domestic policy space
- Ease of implementation of reform proposals

- Pre-crisis dollar standard
- Current dollar standard
- World currency
- SDR
- Multi-currency system
- Global network of central bank foreign currency swap arrangements
- Regional monetary integration
As multilateral arrangements in IMS-reform (e.g. greater role of SDR) remain the target but require institutional changes out of reach for now, developing countries can build on regional and interregional initiatives

- Developing countries may build on a series of regional and interregional initiatives, reducing the need for foreign-exchange accumulation.
- Regional arrangements can incorporate inter-regional swap arrangements and a common fund which could be used by a regional clearing union or reserve pool to increase its liquidity provision capabilities by borrowing on its own.
Regulatory reforms, an unachieved task

- Financial re-regulation initiatives such as increasing capital requirements are a positive step, but remain too timid and narrow.
- Basel III maintained the risk-weighted system and the reliance on (discredited) credit rating agencies, thus failing to prevent high leverage and procyclicality.
- Proposed reforms have insufficiently taken into account the specific needs of developing countries, such as taming speculative cross-border capital flows.
- Developing countries should not be required to apply prudential rules conceived for countries hosting internationally active banks, which result in credit rationing to sectors that need support from a development perspective (e.g. SMEs, start-ups, long-term projects, innovation, etc.).
Despite recent regulatory initiatives, concentration has increased ...

Assets of the five largest banks in selected developed countries or region, as a proportion of total assets of the banking sector, 1998-2011
... and shadow banking remains large

Size of shadow banking sector by different measures 2001-2013

*(Trillions of dollars)*
Credit rating agencies follow ideological prejudices rather than macroeconomic fundamentals

Sovereign rating of developing countries, actual and fitted values

A. Actual vs. fitted values predicted by ideological variables

B. Actual vs. fitted values predicted by fundamental variables

Correlation = 0.66

Correlation = 0.40
External debt in developing and transition economies becoming a threat despite reassuring debt indicators

External debt, selected country groups and China, 1980–2013, billion $

Interest payments on external debt as a proportion of exports, selected country groups and China, 1980–2013, in %
The international economy urgently needs a debt resolution mechanism

- Private finance recurrently creates external debt crises that are frequently translated to governments. At a time of rising fragilities, the international economy lacks a fair and efficient sovereign debt restructuring mechanism (SDRM).

- The present scheme of debt resolution tends to treat solvency crises as liquidity crises, with the official credit extended to indebted governments being used to repay private agents, instead of helping to restore growth. On the contrary, conditionality attached to lending programmes by the IMF and other official sources has a contractionary bias that further deteriorates debt sustainability.

- The present system is fragmented, pro-cyclical and unfair; it deepens the depression in indebted countries and facilitates the bailing out of private creditors. In addition, it allows the action of vulture funds that make restructuring more difficult and affect the interests of both the debtor and other creditors.
Three complementary approaches for improving debt restructuring

1) Contractual or market-based instruments such as collective action clauses to minimize the scope for holdout investors. However, they do not prevent crises, nor do they provide the tools necessary to exiting them;

2) Internationally accepted "soft-law" principles to guide sovereign debt restructuring and recover debt sustainability, which provide soft-law guiding principles, which can be incorporated into domestic legal systems and be applied in the context of international law;

3) A statutory – multilateral treaty-based – approach that defines a set of binding rules and norms (debt standstill, stay of litigation, exchange controls, lending into arrears) leading to a debt restructuring agreement that helps restore growth and debt sustainability.
Ensuring long-term development finance

- Despite abundant international liquidity and low interest rates, many developing countries struggle to obtain sources of long-term international finance for productive investment. This task cannot be entrusted to financial markets, which prefer short-term and low-risk operations.

- Specialized public institutions and mechanisms are crucial:
  - Development banks, which provide long-term finance to the real economy
  - ODA: international commitments should be met and be better used to strengthening the productive economy
  - Sovereign wealth funds, to the extent that they reorient investment decisions
  - Public-private partnerships could also help in financing infrastructure projects. However, they have a chequered record, generate unanticipated fiscal obligations and do not typically create additional finance.
Summary of main recommendations

- To make provision of official international liquidity more stable and predictable, multilateral reform remains desirable target – in meantime, developing countries may build on regional and interregional initiatives, set swap arrangements among Central Banks and reduce the need for reserve accumulation.

- A bolder regulatory agenda is needed: strict separation of retail and investment banking; strong regulation of shadow banking; public oversight of CRAs and their progressive substitution by other mechanisms for risk assessment.

- Developing countries should not be required to apply prudential rules conceived for countries hosting internationally active banks; more active Central Banks with broader mandate.
Summary of main recommendations

• SDRM urgently needed: Sovereign debt management can progress in several fronts: contractual improvements (Collective Action Clauses, *pari passu* clause); internationally accepted Principles to guide sovereign debt restructuring; leading to a statutory approach based on a multilateral treaty defining a set of rules for a debt restructuring that restores growth and debt sustainability

• Specialized public institutions and mechanisms are crucial for provision of long-term development finance, in particular development banks. The international community needs to meet its ODA commitments and to tune it better to strengthening the productive economy